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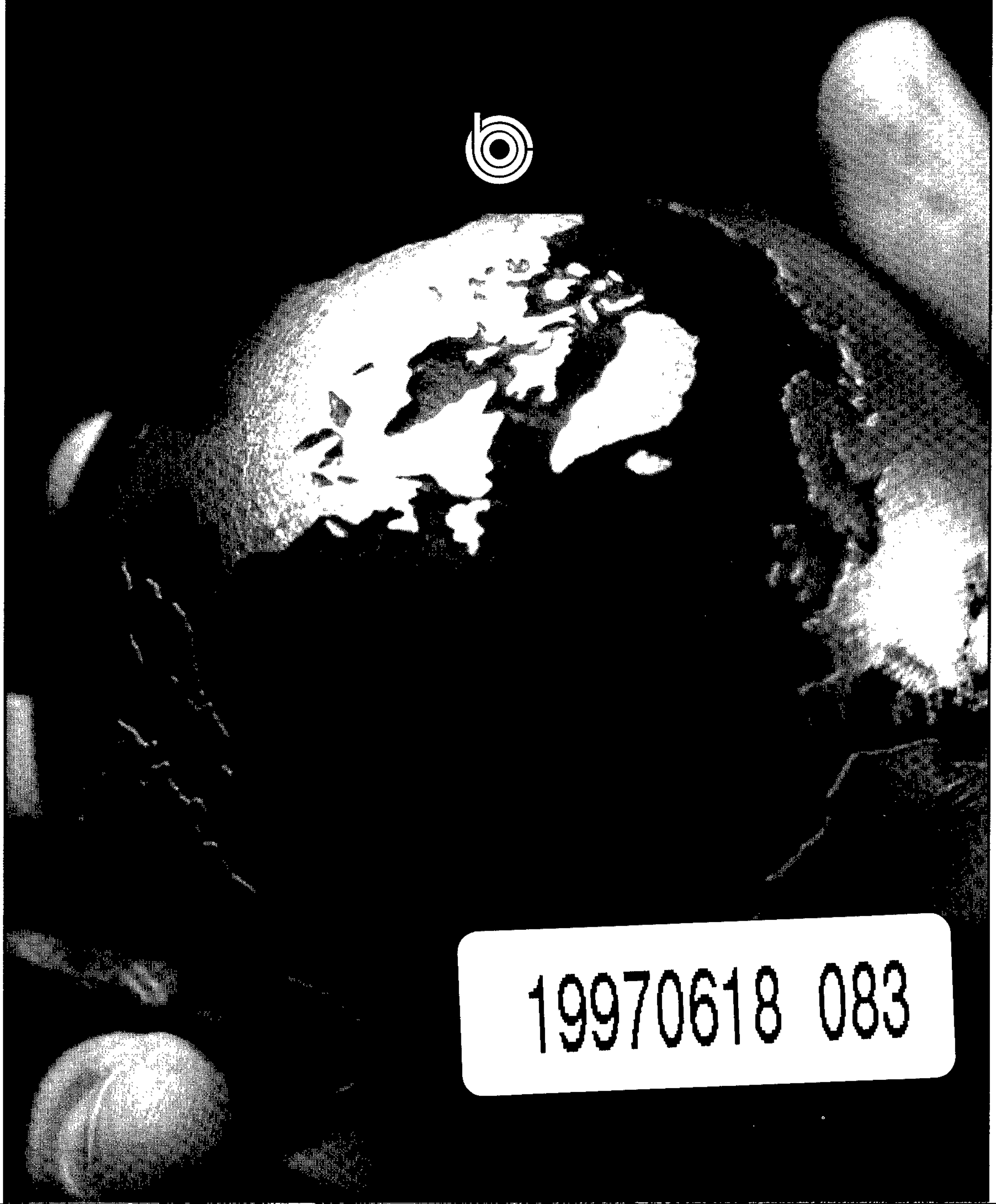
The Role of Foreign Aid in Development



THE ROLE OF FOREIGN AID IN DEVELOPMENT

The Congress of the United States
Congressional Budget Office

NOTES

All years referred to in the study are fiscal years unless otherwise noted.

All dollar amounts are expressed in 1997 dollars unless otherwise noted.

Numbers in text and tables may not add to totals because of rounding.

Preface

What role does foreign aid play in promoting the economic development and improving the social welfare of countries in Africa, Asia, and Latin America? That question is difficult to answer and has been the subject of much debate among development specialists as well as Members of Congress and the American public.

At the request of Congressman Lee Hamilton, the Ranking Minority Member of the House Committee on International Relations, and Senator Nancy Kassebaum, then Chairman of the Subcommittee on African Affairs of the Senate Committee on Foreign Relations, the Congressional Budget Office (CBO) has examined the academic and policy literature for insights into the relationships between foreign aid and development. This study identifies the economic, political, and social conditions that appear to favor development. It also highlights the circumstances under which foreign aid promotes or undermines those conditions. In keeping with CBO's mandate to provide objective analysis, the study does not make recommendations about the future of foreign aid.

Eric J. Labs of CBO's National Security Division prepared the study under the general supervision of Cindy Williams and R. William Thomas. Sheila Roquitte provided general assistance and researched the development histories of Botswana and Zambia. R. William Thomas provided critical assistance in evaluating the empirical studies of foreign aid and development discussed in Chapter 3. The author would like to thank Anna Cook, Robert Dennis, Sunita D'Monte, Victoria Greenfield, Ellen Hayes, Kim Kowalewski, Rachel Schmidt, Marvin Smith, Joseph Whitehill, and Christopher Williams of CBO for their assistance. Many officials of the Agency for International Development (AID), the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the Organization for Economic Cooperation and Development also provided information for the study. In particular, the author would like to thank James Fox, Ellen Peterson, Cheryl Warner, and the staff of AID's mission to Honduras. Anne O. Krueger of Stanford University and Nicholas Eberstadt of the American Enterprise Institute and Harvard University provided many helpful comments on earlier drafts of the study. The author and CBO, however, bear full responsibility for the final product.

Sherry Snyder edited the manuscript, and Christian Spoor proofread it. Judith Cromwell produced drafts of the study. Kathryn Quattrone prepared the report for publication.

June E. O'Neill
Director

May 1997

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Summary

After nearly 50 years of U.S. spending on foreign aid, the purposes and worth of that spending remain issues of debate in the Congress. Financial assistance may be given for strategic, political, economic, or even cultural reasons. This study focuses on aid that is given to promote economic growth and improve human welfare in the developing countries of Asia, Africa, and Latin America.

Determining what role, if any, foreign aid has played in promoting growth and development is difficult for many reasons. First, the dynamics propelling material and social progress are extremely complex historical processes and are influenced by many factors—some possibly remaining unidentified—only one of which is foreign assistance. Second, a great many social and economic trends may occur together with the flow of international aid, which makes determining causality elusive. Third, there is no clear and universally accepted framework for evaluating the impact of various sorts of aid activities. Finally, the data for a research effort designed to determine the role of foreign aid or any other factor are problematic; for example, less than a tenth of the low-income populations of Asia, Africa, and Latin America live in countries with reasonably complete vital statistics, much less economic accounts.

A broad review of the literature on development suggests that foreign aid—in the best of circumstances—will play only a modest role in promoting economic development and improving human welfare. Other factors, such as the quality of a developing country's government and the economic policies it pursues, appear to be considerably more important in promoting growth and development than the quantity, quality, or type of foreign aid the country receives. In fact, how successful foreign aid is in promoting growth depends crucially on those "background conditions." Consequently, this study first examines the broader development context and then considers the role of foreign aid within that context.

Although foreign aid overall appears to have only a marginal effect, it may promote or hinder development, depending on the environment in which that aid is used and the conditions under which it is given. Aid given to countries that are well governed and have adopted market-oriented economic policies may provide a boost to their development. Conversely, aid given to countries that have been governed poorly or have employed restrictive economic policies is less likely to make a positive contribution to their development. In addition, the terms and conditions under which donors give foreign assistance will affect its utility in both of those circumstances.

The Flow of Foreign Aid and Private Capital to Developing Countries

The history of foreign aid spending, particularly U.S. aid, and the rise of private capital flows provide useful background to the analysis. Real (inflation-adjusted) U.S. spending on foreign aid reached a peak of $51 billion (in 1997 dollars) in 1947—the height of postwar reconstruction, which involved large quantities of aid to

help rebuild Europe. In 1997, foreign aid was around $14 billion. At less than 1 percent of federal outlays in that year, U.S. spending on foreign aid was at its lowest level of the postwar era (see Summary Figure 1).

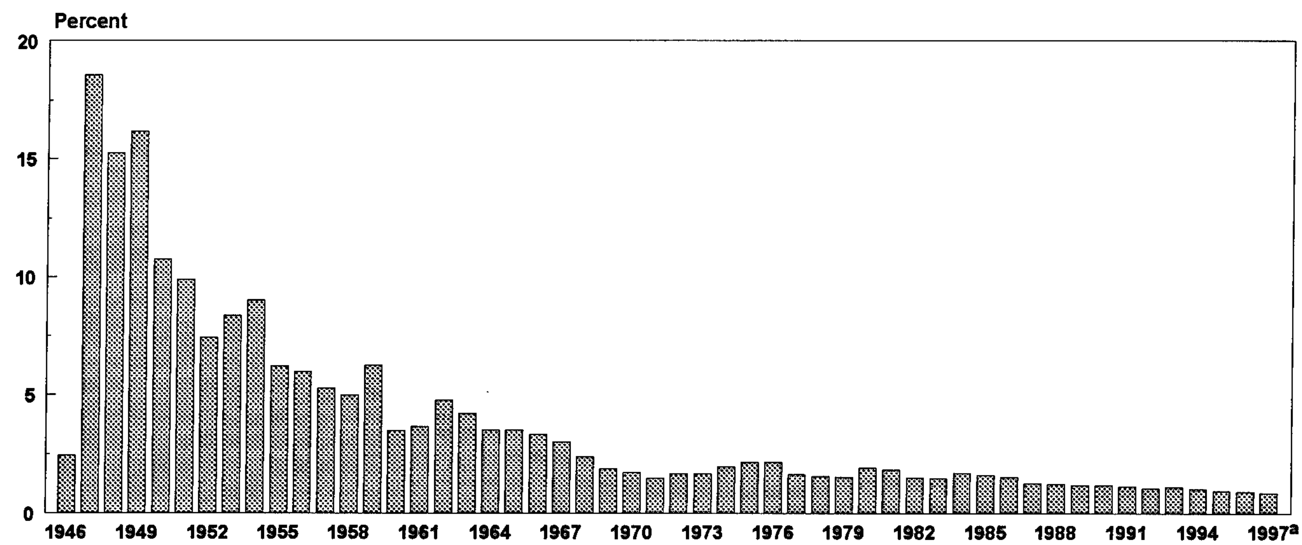
U.S. aid spending has tended to follow the nation's strategic priorities. In the 1940s, Europe received the most U.S. assistance as war-torn European nations rebuilt their national economies and infrastructure. In the 1950s and 1960s, Asian countries—particularly South Korea, Taiwan, and South Vietnam—received about half of U.S. bilateral assistance. In the 1970s, U.S. priorities shifted to the Middle East. The United States began large security and economic assistance programs to Israel and Egypt. Since 1979, the year of the Camp David Accords, countries in the Middle East have received about half of all U.S. bilateral aid.

The foreign aid spending of other bilateral donors has also tended to follow their political or economic interests. Japan, for example, devotes the majority of its aid spending to countries in Asia. France gives most of its aid to its former colonies, as does Britain. That pattern appears to be less true, however, for some of the smaller aid donors; the countries of Scandinavia, for example, devote their resources to the countries they perceive to be most needy.

Multilateral institutions such as the World Bank Group and the regional multilateral development banks have generally favored the poorest countries in the developing world. In 1991-1992, for example, multilateral donors gave over 45 percent of their concessional assistance—grants or loans at a low interest rate—to the least developed countries. By contrast, individual nations gave less than a quarter of their concessional assistance to that same group of countries.

The flow of private capital to developing countries increased substantially in the early 1990s. Those flows include direct investment, lending by international banks, and equity flows (investment in the stock markets of developing countries). They do not include private grants by nongovernment organizations, which have represented less than 5 percent of all private flows. During the 1980s, intergovernmental foreign

Summary Figure 1.
U.S. Spending on Foreign Aid as a Share of Federal Outlays, 1946-1997

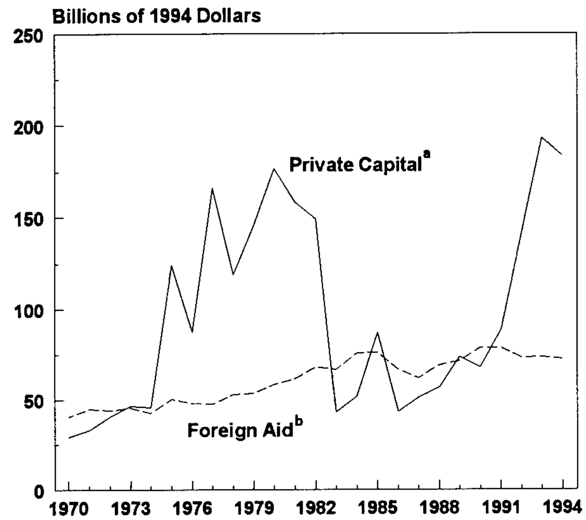


SOURCE: Congressional Budget Office based on *Budget of the United States Government* (for data from 1946 to 1961) and Office of Management and Budget (for data from 1962 to 1996).

NOTE: Data include spending for the International Monetary Fund's Enhanced Structural Adjustment Facility and the Export-Import Bank.

a. CBO estimate.

Summary Figure 2.
Volume of Private Capital and Foreign Aid to All Developing Countries



SOURCE: Congressional Budget Office based on data from the Organization for Economic Cooperation and Development and the World Bank.

a. Includes short- and long-term net flows.

b. Represents net official development finance.

aid, which includes both concessional and nonconcessional funds, was usually greater than private flows. Since 1991, however, foreign aid flows have remained fairly steady in constant dollars, and private flows to developing countries have risen sharply (see Summary Figure 2).

Development and the Role of Foreign Aid

Many different factors contribute to development. Unique historical, geographical, or cultural influences may play an important role in determining whether or how fast a country develops. Factors such as a climate that is inhospitable to productive agriculture are often beyond the control of policymakers in developing countries or their foreign aid donors. Nevertheless, the academic and policy literature on development generally argues that the political and economic choices developing countries make play an important role in determining how well and how fast they develop.

Governance

Three characteristics of governance seem to be important in the development process. First, countries that have had a high measure of political stability and social order are more likely to develop than countries that have experienced instability and chaos. Second, the less corrupt and self-serving a developing country's government, the more likely it is to achieve long-term development. Third, successful development usually depends on developing countries' having the means to protect property rights and maintain an efficient economic system. That may mean having institutions such as a fair and impartial judicial system or a finance ministry and central bank. Investment in elementary education has also been a hallmark of developing countries that have achieved sustained economic growth. As a general rule, democracy does not appear to be necessary for development, though it may be important in some countries.

Domestic Economic Policy

Sound economic management and an outward-oriented trade and industrialization strategy are important economic components of successful development. Noninflationary monetary policies and low budget deficits provide a favorable environment for saving and the accumulation of capital, whereas large deficits, high inflation, and the resulting financial instability work against them. Uncontrolled fiscal policies have contributed to the problem of large deficits as have large government payrolls, inefficient government industries, and various subsidy programs. Governments may expand the money supply to pay for those deficits, a step that often leads to inflation, an overvalued exchange rate, and the production of goods that are less competitive in world markets.

The extent of a country's openness and its integration in the world economy and trading system appear particularly important to development. The discipline of world market prices makes it much harder to sustain distortionary domestic policies that might divert the economy's resources to wasteful and inefficient uses.

The more a country keeps tariff and nontariff barriers low and generally adopts an outward-looking economic policy, the more likely it is to experience sustained economic growth and improved social welfare.

The Role of Foreign Aid

The average amount of foreign aid transferred to developing countries worldwide is small compared with the size of their economies—2 percent to 3 percent of their gross national product. In individual cases, however, that figure can exceed 60 percent in a given year. But more assistance is not always more effective. Receiving too much foreign aid may overwhelm a country's absorptive capacity and thereby undermine the aid's overall effectiveness. Yet even a small quantity can be useful in achieving results, depending on its purpose and how it is spent.

Essentially, foreign aid given to developing countries reinforces what is there. If a country has good government and economic policies, the result is likely to be more good government and economic policies. If a country has a highly corrupt political system and has pursued counterproductive economic policies, the result is usually more of the same. That is not to say that foreign aid never benefits a country that is pursuing counterproductive economic policies. Child immunization programs, for example, are likely to benefit a developing country regardless of its economic policies, although a healthier population will almost certainly be more useful and productive in an economy that is growing briskly than in one that is not.

The way donors give foreign assistance may also influence its usefulness in promoting economic and social development. Aid may be given to alleviate the effects of natural disasters, protect the donor nation's political and strategic interests, or increase the donor's exports. But when aid is given to achieve more than one objective, it may not be as useful to the recipient's growth and development. For example, when aid goes to an ally to further strategic objectives, as U.S. aid went to Honduras in the 1980s, it may reinforce poor economic choices. In addition, other economic or trade policies sometimes undermine the developmental goals of a donor's foreign assistance program. An extreme example occurred when the United States set quotas on textile imports from Bangladesh shortly after providing foreign assistance to its government to expand its textile exports.

Illustrations of Development

To further illustrate the general themes found in the development literature, the Congressional Budget Office (CBO) examined four pairs of developing countries: South Korea and the Philippines, Costa Rica and Honduras, Botswana and Zambia, and Tunisia and Egypt. Those pairs were chosen in part because they have some similarities in geography, climate, population, or political history. In addition, the first country in each pair has achieved greater economic and social development than the second.

Allowing for the idiosyncracies of individual countries, the development histories provide strong support for the themes CBO identified in the scholarly and policy literature. The political and economic policies pursued by South Korea, Costa Rica, and Botswana have been more conducive to development than those adopted by the Philippines, Honduras, and Zambia. As a result, the first three countries have much stronger economic and social indicators than their regional counterparts.

Tunisia and Egypt represent a somewhat different pattern. Although Tunisia is richer than Egypt, the two countries have grown at approximately the same rate. Tunisia, however, has better literacy and infant mortality rates. They both seem to represent examples of countries in which sufficient quantities of foreign aid can generate economic growth, regardless of the economic policy environment. Their ability to sustain that growth in the absence of fundamental reform, however, is open to question.

Chapter One

Introduction

Since the end of the Second World War, the United States has spent over $1 trillion on foreign aid (measured in 1997 dollars). Among the many purposes of that spending is encouraging economic and social development in other countries. Other purposes have included rebuilding Western Europe after World War II, protecting political and strategic interests, promoting U.S. exports, and providing relief during humanitarian crises.

The long-term decline of the foreign aid budget and skepticism in the Congress about the value of foreign aid in promoting development prompt the central question of this study: What role does foreign assistance play in promoting economic growth and improving human welfare in developing countries? The Congressional Budget Office (CBO) attempts to answer that question by summarizing the major findings of the existing scholarly and policy literature on the relationship between foreign aid and development. In addition, to provide enrichment and greater detail, CBO uses the development history of eight countries to illustrate that relationship.

Significance

It seems an appropriate time for foreign aid donors and recipients to take stock of the foreign aid experience. The developing world has changed in the past 40 years. Some developing countries, particularly in East Asia, have grown rapidly since the early 1960s. South Korea and Taiwan, for example, were both aid recipients in the 1950s and 1960s; now they are aid donors. Other countries, however, have fallen into extreme poverty, civil strife, and chaos or have failed to rise above those conditions. Prominent examples of disintegration or extreme poverty include Somalia, the former Yugoslavia, Rwanda, Liberia, and Haiti. In some of those cases, the United States has intervened militarily to provide humanitarian relief and restore order.

The Congress is making large reductions in most discretionary spending programs, including international affairs. In that starker fiscal environment, getting the most out of every foreign aid dollar takes on added importance. So long as economic and social development remains an objective of the U.S. foreign aid program, identifying the conditions that encourage the wise and efficient use of aid funds may promote that objective.

Scope of the Study

This study focuses on three primary issues. First, why do some aid recipients develop more quickly than others? At least 90 developing countries have received substantial U.S. foreign assistance at various times since 1953. Some have managed to grow and develop so that they no longer receive such assistance. South Korea, for example, was a relatively poor country in the 1950s. Today, the World Bank considers it an "upper-middle-income" country, and it no longer receives economic assistance from the United States. In contrast, other countries, despite substantial inflows of foreign aid, have not managed to improve their economic and social well-being. For example, 13 countries that re-

ceived at least $10 million in U.S. economic assistance in 1953 still received at least that much in 1993. Another 26 countries that received that amount in 1973 still received it in 1993.

In addition, are there conditions that must be present before foreign aid can contribute to the development of a recipient country? The vast majority of the scholars writing on development argue that at least in some cases, foreign aid can play a useful role in promoting economic and social progress in developing countries. But the success of aid depends crucially on numerous background conditions that relate to the political and economic policies of the recipient as well as the aid policies of the donor.

Finally, is bilateral or multilateral aid more useful in promoting economic growth and social development in developing countries? Currently, the United States divides its total foreign assistance funding between the Agency for International Development (AID) and various other organizations (see Table 1). Some development experts argue that multilateral agencies should administer most foreign assistance because they are less influenced by parochial concerns. In addition, concentrating aid in one organization would reduce the need to coordinate in one country the programs of many separate donors. Some experts counter, however, that national agencies do a better job of administering foreign aid than do multilateral organizations because the former have a strong in-country presence and thus ensure that their money is spent properly and for the intended objectives.

Table 1.
Organizations Disbursing U.S. Economic Aid

Organization	1997 Appropriation (Millions of dollars)
Agency for International Development[a]	7,723
Other U.S. Aid Organizations[b]	251
World Bank Group	742
Regional Multilateral Development Banks[c]	245
United Nations and Other International Organizations	272
Export-Import Bank	715

SOURCE: Congressional Budget Office.

NOTE: Data exclude military assistance.

a. Includes the Economic Support Fund and humanitarian assistance.

b. The Peace Corps, the Inter-American Foundation, and the African Development Foundation.

c. The Asian Development Bank, the Inter-American Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, and the North American Development Bank.

Analytic Method

CBO sought answers to those questions by relying on the existing academic and policy literature on the relationship between development and foreign aid. By describing the policies and interactions of foreign aid donors and recipients that influence economic growth and improve human welfare in developing countries, this study specifies some catalysts of development and potential causes of underdevelopment. (See Box 1 for a discussion of different definitions of development.) This study highlights those policies and interactions in greater detail by comparing four pairs of developing countries: South Korea and the Philippines, Costa Rica and Honduras, Botswana and Zambia, and Tunisia and Egypt. Those comparisons, however, are more illustrative than analytic. Generally, they cover a 40-year period—1953 to 1993. In examining each country, CBO uses five economic and social indicators to compare them: gross national product per capita, population growth, literacy, infant mortality, and daily calorie consumption per capita. The development history of the eight countries is used in Chapter 4 to provide concrete examples of the themes found in the general literature. CBO will publish a more thorough analysis of three pairs of those countries as separate background papers in late summer.

The eight countries used as illustrations were selected for several reasons. The first country in each pair has achieved relatively greater economic and social development than the second. All eight have received

U.S. and other aid for an extended period. The countries in each pair generally share some similar background conditions such as geographic proximity, population size, climate, land size, and natural resources. They may have other features in common as well, such as similar political histories. Of course, no two countries are exactly alike, but they provide useful comparative illustrations.

Defining Foreign Assistance

A common means of defining and measuring foreign aid is official development assistance, which is used by the Development Assistance Committee of the Organization for Economic Cooperation and Development

Box 1.
What Is Development?

Development means change. Most development specialists would agree on that point. But defining development more precisely than that is problematic. Development is sometimes confused with other terms that are closely related to it but do not mean the same thing.

For the purposes of this study, a country whose economy is growing—that is, its gross national product (GNP) is rising—may not be developing. The rising GNP may simply reflect the increased production and sale of a natural resource such as oil or minerals. *Economic development* is a term that is often used interchangeably with development but implies the transformation of a country's economy from agriculture to industrialization, along with rising per capita income. *Development*, however, describes the process of economic *and* social transformation within a country—both economic growth and economic development as well as improvements in human welfare, such as rising education levels, improvements in health care and life expectancy, and increases in household food consumption. It usually includes a concept of *equity* (the income level of the median household increases along with economic growth) and may include *sustainability* (a process of development that does not make future generations worse off through environmental damage). However, what constitutes "sustainability" remains a hotly disputed issue within the development field.

For example, the World Bank, in its annual *World Development Report*, ranks developing countries on the basis of per capita GNP, though it stresses that other indicators representing education levels, health care, and food production are also important. The United Nations Development Programme, in its annual *Human Development Report*, builds a composite "human development indicator" (HDI), which assigns a value to a country based on its GNP per capita, life expectancy, adult illiteracy, and mean years of schooling. Thus, for some countries, such as Angola or Saudi Arabia, the GNP per capita rank is higher than the HDI rank, indicating that they have the potential to translate more of their income into improved well-being for their people. For other countries, such as China or Costa Rica, the HDI rank is far ahead of their per capita GNP rank, indicating that they have made judicious use of their income to improve the lot of their population.[1]

The Congressional Budget Office (CBO) also uses a broad definition of development. In this study, development encompasses a long-term trend of growth in GNP per capita, rising education levels, improving health conditions, low to moderate population growth, sustainable use of natural resources and the environment, and secure access to adequate amounts of food. In examining individual countries, CBO also puts some emphasis on whether a country is industrializing and whether the broader population is participating in economic growth. Thus, a country that has strong economic and social indicators as well as a vigorous industrial sector and declining poverty rates represents a higher stage of development than a country that has the same economic and social indicators but lacks industrialization.

1. Gerald M. Meier, *Leading Issues in Economic Development*, 6th ed. (New York: Oxford University Press, 1995), pp. 10-11.

(OECD). Official development assistance consists of grants or loans that one government or multilateral organization gives to a developing country to promote economic development and welfare. That assistance must be granted on concessional terms, which in the case of a loan means that at least 25 percent of it must be in the form of a grant. Data on official development assistance also include technical cooperation, such as teaching farmers new techniques or providing advice on making economic reforms; they exclude military assistance, political development programs, export credits, and debt forgiveness for military loans.

The OECD also uses a broader concept called official development finance, which combines official development assistance with other official flows—that is, the financial flows from government organizations in developed countries and multilateral organizations to developing countries. Other official flows usually include loans at or near market rates. Where comparisons between flows of bilateral and multilateral aid are necessary, CBO has used the OECD's official development finance (which shows the total aid picture) and official development assistance (which represents concessional flows only).

For the most part, however, this study uses a broad definition of foreign assistance. It includes all money that would be classified as official development assistance, and it incorporates military assistance, political development programs, export promotion, debt forgiveness, and nonconcessional lending by all bilateral and multilateral organizations. Any money that benefits a developing country—grants, concessional loans, or nonconcessional loans—from a governmental or quasi-governmental organization is considered foreign aid. The only exception is the use of credit from the International Monetary Fund, which is excluded unless otherwise noted.

Aid given for different purposes, of course, will probably have different effects on development. Assistance designed to foster economic reforms or improve production methods is likely to have a greater impact on development than military assistance, which aims to build stronger armed forces in the recipient country. But all such resources may influence the development process. For example, military aid, which is not normally considered to be development assistance, may enable a country to devote a greater percentage of its resources to development programs than if it did not receive military assistance. More likely, however, military assistance simply enables a country to build stronger armed forces than would have been possible in the absence of such aid. Thus, although the primary focus of this study is the role of economic assistance in development, other forms of assistance are addressed when appropriate.

Furthermore, both gross and net aid flows have advantages and disadvantages in analyses of the effect of foreign assistance on development. Gross aid flows capture all the resources a developing country receives in loans and grants from donor organizations and countries. Net flows represent the same resources but exclude loan repayments. Gross flows more accurately demonstrate how large a presence foreign aid has had in a particular country, but by excluding loan repayments they present a distorted picture of the actual resources a country receives in a given year. For example, gross aid flows may be more useful in understanding how aid can contribute to policy dialogue and reform in a developing country, because gross aid flows do a better job of illustrating the leverage a donor may have than do net flows. However, if the objective is to calculate the macroeconomic effect of aid flows, then net figures are more appropriate. This study uses data on both measures of aid.

Limitations of the Study

CBO explores the effects of foreign assistance in general terms. Attributing specific economic or social improvements in a country to a particular source of foreign aid is beyond the scope of this study. The reasons for that qualification are varied and complex. First, the dynamics propelling material and social progress are extremely complex historical processes and are influenced by many factors—some possibly remaining unidentified—of which foreign assistance is only one. Second, a great many social and economic trends may happen to move in sequence with international aid flows, which makes determining the impact of any one factor elusive. And third, no clear and universally accepted framework exists for evaluating aid activities.

In addition, although the country comparisons provide a more in-depth view of the development process,

this study does not discuss countries that have managed to develop with little or no aid. For example, compared with other countries in Latin America such as Bolivia or El Salvador, Chile has received very little aid. Yet Chile achieved an average annual growth rate of 3.6 percent in per capita gross national product between 1980 and 1993—better than most of its neighbors, who had negative annual growth rates during the 1980s.

CBO does not attempt to evaluate the various bilateral and multilateral institutions through which foreign aid is administered. This is not a study of AID, the World Bank Group, or any other organization that provides assistance to developing countries. Such a detailed analysis of the programs of individual aid-giving organizations is beyond the scope of this analysis and the resources available. Thus, although the study refers to specific organizations—AID, after all, has been at the heart of the aid-giving experience for the past 30 years —it does not assess their effectiveness.

The World Bank Group, the Organization for Economic Cooperation and Development, the Agency for International Development, and other agencies provided most of the statistical data on developing countries for this study. But the data are not always complete or accurate. In other instances, statistics relating to economic or human welfare may have been manufactured by a developing country to satisfy the various rules of organizations dispensing foreign assistance. Such information, therefore, should be used with caution. Nonetheless, sufficient data are available to conduct a broad assessment of the conditions that promote development.

Chapter Two

The Flow of Foreign Aid and Private Capital to Developing Countries

Foreign aid is the subject of intense debate within academia as well as among Members of Congress and the American people. All parties to that debate marshall strong arguments in favor of their respective position. Yet to understand the role of foreign aid in promoting development, one must first understand the history and objectives of U.S. foreign aid as well as those of other bilateral and multilateral donors. The aid resources of bilateral donors, including the United States, tend to follow the donor's political and strategic priorities, not those of the countries that have the greatest need from a development perspective. Though much smaller than the amount of aid given by bilateral donors, the money given by multilateral institutions tends to go mostly to the poorest countries. At the same time, the flow of international private capital to developing countries is taking on an increasing importance in the development context, having surpassed flows of foreign aid in total volume since the early 1990s.

What Do Proponents Believe Aid Will Achieve?

Proponents of continued or greater funding for U.S. foreign aid programs employ a variety of political, humanitarian, and economic rationales to make their case. As one might expect, those rationales extend beyond the issue of promoting economic and social development in other countries.

Aid Has Often Been Effective

Foreign assistance has often been effective in meeting its goals. Aid was effective in helping to rebuild Europe after World War II. With respect to development, aid helped eradicate polio, greatly reduce the incidence of small pox, increase life expectancy, and reduce fertility rates around the world. Although the United States cannot expect aid to solve all problems, many of the efforts the country has attempted with its foreign aid program have been effective.[1]

The United States Should Provide Humanitarian Assistance

The United States has been very generous when humanitarian disasters have occurred in various parts of the world. Such crises may be caused by natural disasters, political instability, or civil conflict—all of which may create large flows of refugees. Foreign aid can do little to prevent earthquakes, but it can lessen the severity of droughts and famine by encouraging better farming methods and developing and employing drought-resistant strains of crops. Similarly, foreign aid may be able to reduce the incidence of civil conflict by helping to create more economic opportunity in developing countries.

1. David Gordon, Catherine Gwin, and Steven W. Sinding, *What Future for Aid?* Occasional Paper 2 (Overseas Development Council, November 1996), pp. 11-13.

Development in Other Countries Enhances U.S. Security

A potential threat facing the United States after the Cold War may be the spread of weapons of mass destruction, especially if combined with political instability. An internal conflict in a developing country that became a regional conflict would have dire consequences for U.S. allies if it involved use of nuclear, chemical, or biological weapons—not to mention the potential impact on the regional and global environment. In 1994, "a brief survey of the world's trouble spots show[ed] a fairly striking correlation between economic malaise on the one hand and domestic unrest and political instability on the other."[2] If the United States can address those problems by using its foreign aid to help to create economic opportunities and invest in human capital, then the chance of conflict may be reduced.

Foreign Aid Helps Provide Public Goods in Developing Countries

Many developing countries do not have sufficient funds to provide public goods such as education or transportation systems or clean water and waste disposal facilities. Although such goods are essential for development, their economic rate of return is so uncertain that private investors are unwilling to provide them on a large scale. Foreign aid can substitute for private capital in those instances, providing the funds for investment in public goods that the international capital market will not supply to those developing countries or would supply at a high interest rate.

Why Do Others Criticize Aid Programs?

Critics of foreign aid use a variety of political, strategic, and economic rationales to make their case.

2. Congressional Budget Office, *Enhancing U.S. Security Through Foreign Aid* (April 1994), p. 5.

Aid Is Often Ineffective

One argument is that foreign aid does not contribute significantly to economic progress in developing countries. Aid that is intended to foster development may enable some regimes to divert money to other, nonproductive activities. Aid is wasted in countries that do not have the technical or administrative ability to absorb and use it properly. Furthermore, the recipients of aid may use it to fund projects that are poorly conceived and planned. Examples of roads being built and going unmaintained and unused, or other large projects destroying more productive resources than they create, are not uncommon. It follows, critics argue, that development should be left to market forces. The private sector in developing countries would be much more efficient in promoting economic growth than development specialists, they say.

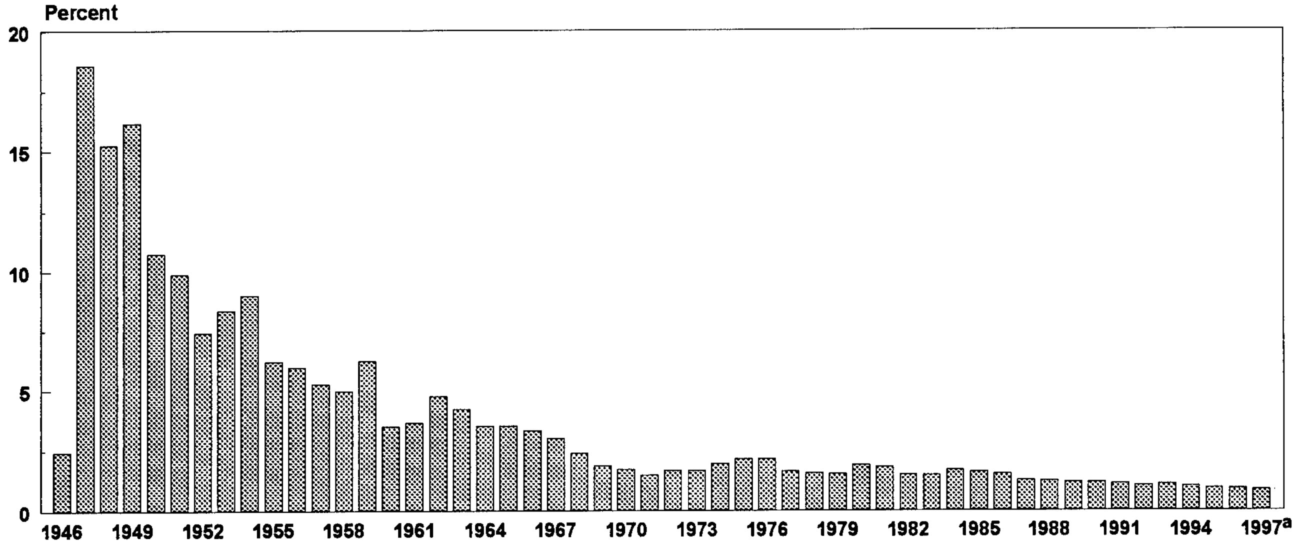
Aid Often Harms Developing Countries

Peter Bauer has argued that aid has serious, distorting consequences in the political life of recipient countries. Aid is generally transferred to the government of those countries, which tends to increase the government's power, resources, and patronage relative to the rest of society and, consequently, the stakes in any struggle for control of that power. People will spend relatively more of their time focused on the outcome of political and administrative decisions, thereby diverting attention, energy, and resources from more productive economic activities. That may encourage tension and disturbances that can lead to the outbreak of civil armed conflict.[3]

In many cases, foreign aid has sustained governments in their pursuit of economically counterproductive political and economic policies. Such policies include the persecution of particular groups, restrictions on private trade and the inflow of private capital and enterprises, confiscation of property, price policies that discourage agricultural production, and the expropriation of foreign capital and enterprises. To add insult to

3. Peter Bauer, "Foreign Aid: Mend It or End It?" in Peter Bauer, Savenaca Siwatibau, and Wolfgang Kasper, *Aid and Development in the South Pacific* (Australia: Center for Independent Studies, 1991), p. 9.

Figure 1.
U.S. Spending on Foreign Aid as a Share of Federal Outlays, 1946-1997



SOURCE: Congressional Budget Office based on *Budget of the United States Government* (for data from 1946 to 1961) and Office of Management and Budget (for data from 1962 to 1996).

NOTE: Data include spending for the International Monetary Fund's Enhanced Structural Adjustment Facility and the Export-Import Bank.

a. CBO estimate.

injury, when the pursuit of such policies worsens the economic performance of an aid recipient, the country may qualify for still more aid because its situation is deteriorating.[4]

Economic Growth in Developing Countries May Not Be Beneficial for the United States

One might argue that even if U.S. foreign aid does the job of promoting economic growth overseas, it will have adverse consequences for the United States. Economic growth among developing countries means that they have become competitors in the global market. Cheaper wages in developing countries allow foreign competitors to charge prices that are lower than those for comparable U.S. goods in world and domestic markets, critics would claim, thus causing the United States to lose jobs.

Aid Should Support Only U.S. National Interests

Another argument is that the United States should target its foreign aid dollars toward countries and policies that directly support U.S. national interests. Helping all the poor people of the world, though laudable, is impractical. The United States should, therefore, enable countries to defend themselves, reward its friends, and reinforce success where it is occurring. When viewed in that light, helping the poorest of the poor may be an ineffective use of U.S. aid dollars.

Pattern of U.S. Spending on Foreign Aid Since World War II

Historical spending on foreign aid suggests that since the 1950s, such aid has not been a particularly high

4. Ibid., pp. 9-10.

priority of U.S. policymakers. Another, perhaps more important, point is that foreign aid has been used primarily as a foreign policy tool. Political and security interests have dominated the allocation of U.S. foreign assistance in the 50 years since the end of World War II. That ap-proach is reflected in changes in geographic emphasis in the allocation of U.S. aid over time. Promoting economic development and human welfare has been an objective of U.S. foreign aid but, overall, a secondary one.

Real (inflation-adjusted) U.S. spending on foreign aid has fluctuated from year to year but has been on a downward path since the 1960s, both in dollar terms and as a share of all federal outlays. It reached a high of $51 billion (in 1997 dollars) during postwar relief and reconstruction in 1947. By 1997, funding for foreign aid had fallen to around $14 billion.

As a percentage of federal outlays, U.S. spending on foreign aid reached its lowest level in the post-World War II era in 1997, falling to less than 1 percent (see Figure 1 on page 9). That share compares, for example, with almost 16 percent for defense, almost 21 percent for Social Security, and 15 percent for interest on the national debt. Although many major categories of federal spending have increased substantially over the past 10 years, foreign aid outlays fell by 32 percent between 1985 and 1995. Overall federal spending rose by almost 15 percent during that period.

Geographic Distribution of Aid Since 1945

With the onset of the Cold War in the late 1940s, a critical priority of Washington was to rebuild the war-torn economies of Western Europe. The United States created the Marshall Plan—named after Secretary of State George Marshall, who proposed it—which provided billions of dollars in aid to various European countries. The Marshall Plan, along with the military and economic aid programs to Greece and Turkey, constituted the bulk of U.S. bilateral aid between 1946 and 1952. Europe received 82 percent of U.S. bilateral assistance —nearly $267 billion—during that period.

In the 1950s and 1960s, the focus of U.S. spending on foreign aid shifted from Europe to Asia, especially South Korea, Taiwan, and later South Vietnam. Between 1953 and 1975, that region received about half of all U.S. bilateral assistance. Bilateral military assistance, like the Lend-Lease program before the United States entered World War II, was designed to support strategic and politically important U.S. allies around the globe. It both signaled a U.S. political commitment to recipient countries and helped them build stronger military capabilities. In that sense, the objective of U.S. military assistance given to countries today does not differ materially from that of 40 years ago.

In the 1970s, U.S. funding priorities shifted from Asia to the Middle East. The level of aid given to Asian countries declined dramatically after North Vietnam conquered South Vietnam in 1975 and the United States withdrew all foreign assistance to that country (see Table 2). In addition, U.S. aid programs to South Korea and Taiwan had been winding down since the early 1970s. However, the 1979 Camp David peace accords between Israel and Egypt inaugurated large bilateral security and economic assistance programs to both of those countries. Other recipients in the region have included Jordan, Tunisia, and Morocco. Since 1979, the Middle East has received about half of U.S. bilateral assistance.

Table 2.
U.S. Regional Aid as a Share of All Bilateral Aid (In percent)

Region	1955	1965	1975	1985	1995
Africa	1	5	6	11	12
Asia	54	52	51	14	6
Europe/NIS	36	13	5	14	18
Latin America	3	20	11	15	9
Middle East and North Africa[a]	6	10	27	45	55

SOURCE: Congressional Budget Office based on data from the Agency for International Development.

NOTE: NIS = newly independent states (of the former Soviet Union).

a. The Agency for International Development reports these data under a category called Near East.

With the exception of the early 1960s and the mid-1980s, Latin America has never received large amounts of U.S. bilateral aid. Its share of U.S. foreign aid spending never exceeded 25 percent of the bilateral aid budget. President Kennedy's Alliance for Progress program briefly boosted aid to the region, and the effort to thwart the spread of communism in Central America in the 1980s benefited El Salvador, Honduras, and Costa Rica. Since 1979, Latin American countries have received about 13 percent of U.S. bilateral assistance.

Finally, Africa has been a relatively low priority in the U.S. foreign aid program. It has received about 10 percent of U.S. bilateral assistance in the 1990s.

Historical Objectives of Aid

During World War II, the U.S. view of foreign aid as a foreign policy tool changed dramatically. Before the war, with the notable exception of the Lend-Lease program, the United States devoted few resources to foreign aid and international institutions. After the war, the United States emerged as the world's strongest economic power. Its gross national product exceeded that of the six next largest powers.[5] The war had devastated large parts of Europe and Asia. In response, U.S. policymakers began to fund programs that could be broadly defined as foreign aid. Nevertheless, U.S. strategic interests have determined where most U.S. foreign aid has been spent.

Europe was an immediate concern. Postwar aid to Europe had two major functional and political objectives. First, part of the program provided immediate disaster relief to countries devastated by the war. That meant supplying them with food, clothing, and medicine—the basic necessities to prevent starvation and disease. Second, the Marshall Plan assisted Western European countries, including the western part of Germany, in rebuilding their economies and thereby restoring and ultimately elevating their standard of living. Politically, the program was intended to reduce or eliminate the wretched economic and social conditions that some U.S. policymakers believed might cause the peoples of Western Europe to turn to communism for a solution.[6] The Italian and French communist parties in particular were quite strong in the late 1940s. In addition, restoring the prosperity of Western European countries would make them better able to contribute to their own military defense against what appeared to be an increasingly menacing Soviet Union.

In the 1950s, the United States also inaugurated development and food assistance programs for developing countries. The original political and functional objective of those programs, as outlined by President Truman in the Point IV program of 1949, was to give other countries access to the skills and knowledge that generate widespread affluence. That approach differed from the Marshall Plan in that the countries of Western Europe required, for the most part, help in reconstructing a fully developed industrial economy: the technical skill and high levels of human capital already existed there. Those conditions, however, were not likely to be found in the countries receiving aid under Point IV. But by 1960, more and more of U.S. development assistance went to countries that were friendly to the United States.[7]

By 1961, President Kennedy was arguing that development assistance *was* security assistance, that subversion and revolt around the world fed on social injustice and economic chaos. Consequently, he signed the Foreign Assistance Act of 1961, which set up the Agency for International Development.[8] The mission of that agency was to supervise and administer the U.S. development assistance program. The legislation ensured that most of that assistance would go to countries that were politically important to the United States. The act and its subsequent amendments also included numerous specific functional and political objectives.

Today, the Foreign Assistance Act, as amended, instructs the executive branch to pursue at least 32 separate goals. They include reducing infant mortality, controlling population growth, reducing illiteracy, preserving biological diversity, supporting human rights, encouraging private U.S. investment, and strengthening

5. Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York: Random House, 1987), p. 369.

6. Vernon W. Ruttan, *United States Development Assistance Policy: The Domestic Politics of Foreign Economic Aid* (Baltimore: Johns Hopkins University Press, 1996), pp. 38-41, 50.

7. Nicholas Eberstadt, *Foreign Aid and American Purpose* (Washington, D.C.: American Enterprise Institute, 1988), pp. 25-31.

8. Ibid., p. 33.

Box 2.
Objectives in the Foreign Assistance Act of 1961, as Amended

1. Alleviating the worst physical manifestations of poverty among the world's poor majority.
2. Promoting conditions that enable developing countries to achieve self-sustaining economic growth with equitable distribution of benefits.
3. Integrating developing countries into an open and equitable international economic system.
4. Increasing the opportunity and capability for the poor to participate in the development process.
5. Reducing infant mortality.
6. Controlling population growth.
7. Increasing agricultural productivity per unit of land through small-farm, labor-intensive agriculture.
8. Contributing to improvements in the health of the greatest number of poor people in developing countries.
9. Reducing illiteracy, extending basic education, and increasing manpower training in skills related to development.
10. Helping developing countries to develop, produce, and effectively use energy.
11. Assisting the development of the private sector in developing countries.
12. Integrating women into national economies to enhance their status and to further the development process.
13. Supporting human rights by not providing assistance to countries that engage in a consistent pattern of gross violations of these rights.
14. Reducing environmental degradation and promoting natural resources management.
15. Encouraging conservation and sustainable management of tropical forests.
16. Preserving biological diversity.
17. Using, whenever feasible, private and voluntary organizations to implement development activities.
18. Strengthening the development and use of cooperatives.
19. Eliminating illicit narcotics production.
20. Establishing and upgrading the institutional capacities in developing countries.
21. Demonstrating American ideas and practices in education and medicine to citizens of other countries through U.S. schools, libraries, and hospitals abroad.
22. Assisting developing countries in marshalling resources for low-cost shelter.
23. Encouraging democratic institutions in developing countries.
24. Encouraging the development capacities of U.S. educational institutions.
25. Educating the U.S. public concerning developing countries.
26. Providing international disaster assistance.
27. Emphasizing the use of smaller, cost-saving, labor-using technologies.
28. Encouraging U.S. private investment in U.S.-sponsored economic and social development programs.
29. Encouraging regional cooperation among developing countries.
30. Promoting policy reforms in developing countries to achieve economic growth with equity.
31. Assisting developing countries to increase their national food security.
32. Addressing the shelter and urbanization needs of developing countries, such as municipal management and finance, water and sanitation, and infrastructure.

SOURCE: General Accounting Office, *Foreign Assistance: AID Strategic Direction and Continued Management Improvements Needed*, NSIAD-93-106 (June 1993), pp. 66-67.

Table 3.
U.S. Spending on Foreign Aid by Major Category and Administering Agency

Category	Administering Agency[a]	1997 Appropriation (Millions of dollars)
Military Assistance	Department of Defense	3,400
Bilateral Development Assistance	Agency for International Development	2,500[b]
Economic Support Fund	Agency for International Development	2,300
Humanitarian Assistance	Agency for International Development	1,700
Aid to Eastern Europe and the Former Soviet Union	Agency for International Development	1,400[c]
Multilateral Assistance	Department of the Treasury	1,300

SOURCE: Congressional Budget Office.

a. Many different organizations may play a role in determining who receives assistance, not just the administering agency.

b. Does not include funding for development-related agencies such as the Export-Import Bank or the Overseas Private Investment Corporation.

c. Includes funding for the Cooperative Threat Reduction program, which is administered through the Department of Defense.

the development and use of cooperatives. (For a complete list of all specified goals of the U.S. development assistance program, see Box 2.)

Overall, the end of the Cold War has brought few changes in the objectives of U.S. foreign aid. Egypt and Israel remain the largest recipients of U.S. bilateral assistance. However, other countries that had received hundreds of millions of dollars in U.S. assistance, in part because they were allies during the Cold War (including Pakistan and some Central American states), have found their funding cut.

Composition of U.S. Spending on Foreign Aid

In 1997, U.S. spending on foreign aid totals nearly \$14 billion.[9] The foreign aid budget can be roughly divided into six categories: military assistance, bilateral development assistance, the Economic Support Fund, humanitarian assistance, aid to Eastern Europe and the republics of the former Soviet Union, and multilateral assistance (see Table 3). Three agencies oversee that spending, but numerous other agencies participate in allocating and distributing that aid.

Military Assistance

Most U.S. military assistance is from the Foreign Military Financing (FMF) program, which is administered by the Department of Defense. It provides grants and loans that enable foreign governments to purchase military equipment from the United States. Lately, FMF has focused on grants for a few, mostly Middle Eastern, recipients. In 1997, assistance to Egypt and Israel consumed 94 percent of the program's appropriation of almost \$3.3 billion.

Another important, albeit far less expensive, program is International Military Education and Training, which cost about \$40 million in 1997. That program provides grants to countries for training foreign military officers and personnel. Funding for military-to-military contact programs and some peacekeeping operations

9. Foreign aid falls within budget function 150 (international affairs). That function also includes spending for the conduct of foreign affairs and for information and exchange programs—two activities that in 1997 accounted for nearly \$5.1 billion.

also belongs in this category. (For a complete breakdown of spending for military assistance, see Table A-1.)

Bilateral Development Assistance

In 1997, the United States allocated about $2.5 billion for bilateral development assistance. Such assistance is intended to encourage equitable and sustainable economic growth in many developing countries. The programs and projects vary widely across many different sectors, including agriculture, health, private enterprise, education, population, the environment, and economic reform. In 1973, the Congress amended the Foreign Assistance Act of 1961 to require U.S. development assistance programs to emphasize helping the poorest segments in developing countries. Other programs such as the Trade and Development Agency, the Export-Import Bank, and narcotics control programs have purposes that overlap those of the bilateral development assistance programs but are funded separately —approximately $1.2 billion in 1997 (see Tables A-2 and A-3).

Economic Support Fund

The Economic Support Fund (ESF), administered through AID, explicitly directs economic aid to countries that are deemed to be politically or strategically vital to the security of the United States. But the form ESF moneys take is often similar to development assistance. It may also include cash transfers into a country's bank account. Recently, a high proportion of this aid has gone to countries in the Middle East, with Israel and Egypt receiving 85 percent of the $2.3 billion program in 1997.

Humanitarian Assistance

The United States provides money to alleviate humanitarian crises around the globe. About half of the $1.7 billion the United States spends on humanitarian assistance funds emergency food programs in developing countries. The remainder is provided to assist refugees and help alleviate natural disasters or man-made problems such as civil war. That money is not intended or expected to promote development. It is usually distributed by private and multilateral organizations acting on behalf of AID. Recent recipients have included Somalia and Rwanda (see Table A-4).

Aid to Eastern Europe and the Former Soviet Union

With the end of the Cold War, new programs in foreign aid have been created to assist countries of the former Soviet bloc in their transition to democracy and free-market economies. Aid to Eastern European countries is funded through the Support for East European Democracy Act, and aid to the former Soviet republics through the Freedom Support Act. In addition, a separate program funded through the Department of Defense—the Cooperative Threat Reduction program (also known as Nunn-Lugar)—provides money and technical expertise to assist the states of the former Soviet Union in dismantling nuclear weapons. In 1997, foreign assistance to Eastern Europe and the former Soviet Union totaled about $1.4 billion (see Table A-5).

Multilateral Assistance

The United States also contributes substantial funding to various multilateral institutions that provide economic assistance to developing countries. The most prominent are the World Bank Group, the International Monetary Fund (IMF), and some agencies affiliated with the United Nations, such as the United Nations Children's Fund and the United Nations Development Programme. Technically, both the World Bank Group and the IMF are "specialized agencies" of the United Nations, though they are not subordinate administratively to that organization. The World Bank and the regional multilateral development banks have programs that lend money at both concessional and nonconcessional rates. The concessional loans are intended for low-income countries, and the nonconcessional loans for middle-income countries. In 1997, the United States allocated $1.3 billion to multilateral assistance (see Table A-6).

Bilateral Assistance of Other Countries

As other countries recovered from the devastation caused by the Second World War, they began to devote more money to foreign aid. The United States was the primary donor of foreign assistance in the first 20 years after the war, when it was also the dominant economic power. Since that time, however, other countries have grown in importance as foreign donors.

In 1960, the major Western nations decided to formalize and cooperate in the aid-giving process. They set up the Organization for Economic Cooperation and Development to promote economic development and trade among member and nonmember nations. One of

Box 3.
Bilateral and Multilateral Donors

Many countries and organizations provide foreign assistance to other countries. This box lists all bilateral and major multilateral donors.

Bilateral Donors

Australia
Austria
Belgium
Canada
China[1]
Czech Republic
Denmark
Finland
France
Germany
Greece
Iceland
India[1]
Ireland
Italy
Japan
South Korea
Kuwait
Luxembourg
Netherlands
New Zealand
Norway
Portugal
Spain
Saudi Arabia
Sweden
Switzerland
Taiwan
Turkey
United Arab Emirates
United Kingdom
United States

Multilateral Donors

African Development Bank
- African Development Fund

Arab agencies
Asian Development Bank
- Asian Development Fund

Caribbean Development Bank
Commission of the European Communities
European Bank for Reconstruction and Development
Inter-American Development Bank
- Inter-American Investment Corporation
- Fund for Special Operations
- Enterprise for the Americas Multilateral Investment Fund

International Fund for Agricultural Development
International Monetary Fund
United Nations
- Food and Agriculture Organization
- United Nations Development Programme
- United Nations Fund for Population Activities
- United Nations Children's Fund
- United Nations Programme of Technical Assistance
- United Nations High Commissioner for Refugees
- World Food Programme
- Other United Nations programs

World Bank Group
- International Bank for Reconstruction and Development
- International Development Association
- International Finance Corporation
- Multilateral Investment Guarantee Agency
- Global Environment Facility

SOURCE: Congressional Budget Office based on information from the Organization for Economic Cooperation and Development and the World Bank.

1. India and China receive large amounts of foreign assistance, but they have also contributed a modest amount of aid to a few developing countries.

the special committees of the OECD is the Development Assistance Committee. Its members have agreed to make more money available to developing countries, help coordinate their aid programs, and make more resources available to multilateral donors. In 1994, developing countries and multilateral organizations received $59 billion in official development assistance; 17 percent of that amount was from the United States. (For a list of all bilateral and multilateral aid donors, see Box 3 on page 15.)

The foreign aid spending of other bilateral donors, however, has also tended to follow their political or economic interests. Japan, for example, devotes the majority of its aid to countries in Asia with whom it has strong economic ties. France gives most of its aid to its former colonies, as does Britain. In contrast, some of the smaller aid donors, such as the countries of Scandinavia, tend to devote their resources to countries that they perceive as being the most needy.

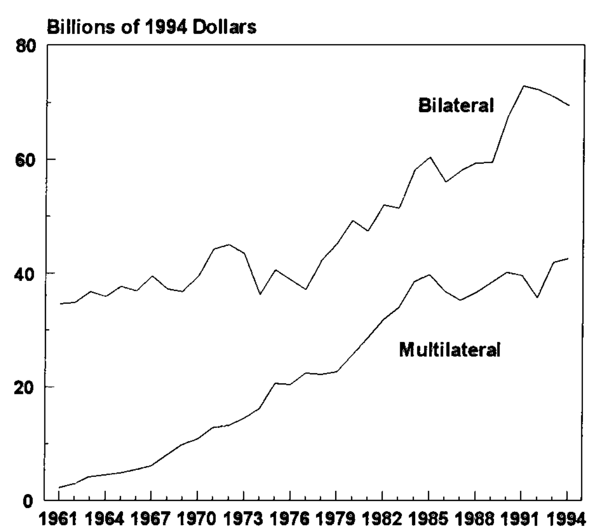
Multilateral Assistance Programs

In addition to its direct aid program, the United States helped organize and fund a number of multilateral organizations at the end of World War II, including the International Monetary Fund, the World Bank, and the United Nations. The functional and political objectives of those institutions were closely related. The financial institutions—the IMF and World Bank—were to help regulate the international economy, promote trade, promote economic growth, and create a mechanism for exchanging and converting the currencies of member countries. Those institutions, their creators hoped, would help prevent a repetition of the Great Depression and the high tariffs that it inspired. The political institution—the United Nations—organized the world's nations into a collective body. Members hoped that it would provide a means whereby states could resolve disputes among themselves or, if necessary, punish aggressors who chose to make war on other states.

Assistance from multilateral institutions has grown faster than that from bilateral donors since 1961 (see Figure 2). In the 1960s, the members of the OECD agreed to try to give more money to multilateral institutions that dispense foreign assistance. That commitment was made in part because the OECD countries, who fund the multilaterals, believed that they needed an instrument for giving foreign aid that would be relatively free of the domestic political and foreign policy concerns of individual donor countries.

Since the early 1980s, multilateral donors have given relatively more of their concessional assistance to the least-developed countries than have bilateral donors. According to data from the Development Assistance Committee, 45 percent of the official development assistance (ODA) from multilateral organizations went to the least-developed countries in the 1991-1992 period, down from 51 percent in the 1981-1982 period. In contrast, bilateral donors allocated only a quarter of their resources to the same group of nations in the early 1980s. Bilateral ODA was fairly evenly distributed among most developing nations in the early 1980s, though by the 1990s most of it was again going to the poorer countries. That trend is also occurring with respect to all foreign assistance provided to developing

Figure 2.
Volume of Official Development Finance Provided by Bilateral and Multilateral Donors



SOURCE: Congressional Budget Office based on data from the Organization for Economic Cooperation and Development.

NOTE: Official development finance includes grants and concessional loans as well as nonconcessional loans or credits from individual countries and multilateral organizations.

Table 4.
Distribution of Foreign Aid by Income Group (In percent)

Income Group	Bilateral 1981-1982	Bilateral 1991-1992	Multilateral 1981-1982	Multilateral 1991-1992
	Official Development Finance			
Least-Developed Countries[a]	20	18	27	22
Low-Income Countries	22	41	20	40
Lower-Middle-Income Countries	16	23	20	22
Upper-Middle-Income Countries	42	13	33	17
High-Income Countries	n.a.	5	n.a.	0
Total	100	100	100	100
	Official Development Assistance			
Least-Developed Countries[a]	25	23	51	45
Low-Income Countries	25	47	28	39
Lower-Middle-Income Countries	17	21	13	11
Upper-Middle-Income Countries	32	6	8	4
High-Income Countries	n.a.	4	n.a.	0
Total	100	100	100	100

SOURCE: Congressional Budget Office based on data from the Organization for Economic Cooperation and Development.

NOTES: Official development finance includes official development assistance (grants and concessional loans) as well as nonconcessional loans or credits from individual countries and multilateral organizations. Data reflect gross flows.

n.a. = not available.

a. Includes China and India.

countries. In the early 1980s, some 42 percent of bilateral and 33 percent of multilateral official development finance (ODA plus the nonconcessional flows) went to upper-middle-income countries. By the 1990s, those figures were 13 percent and 17 percent (see Table 4).

Geographically, bilateral donors distribute the vast majority of their official development assistance across the major regions of the developing world. Multilateral donors, however, have tended to concentrate their ODA in Africa and Asia, where most of the world's poorest people live (see Table 5).

Flow of Private Capital to Developing Countries

The amount of private capital going to developing countries increased substantially in the early 1990s. Private capital includes direct investment, international bank lending, stock market investment, and, to a much smaller degree, assistance from private organizations such as the International Red Cross. During the 1980s, the amount of official development finance was usually greater than private capital flows (excluding aid from private organizations). Since 1991, however, private flows to developing countries have risen sharply, and foreign aid flows have remained fairly steady (see Figure 3). Unlike foreign assistance, private capital has tended to go to developing countries that appear likely to provide the greatest economic return.

Foreign direct investment (FDI) represents the largest component of private capital going to developing countries—around 50 percent, or $80 billion, in 1994. According to the World Bank, most FDI goes to countries in Latin America and Asia. Countries in sub-Saharan Africa attracted only $3 billion in 1994. In fact, seven countries—Brazil, Argentina, Malaysia, Mexico, Indonesia, Thailand, and especially China—

Table 5.
Geographic Distribution of Foreign Aid (In percent)

Region	Official Development Finance		Official Development Assistance	
	Bilateral	Multilateral	Bilateral	Multilateral
Sub-Saharan Africa	26	25	29	45
Middle East and North Africa	22	11	24	8
Asia	27	34	28	35
Latin America	19	25	12	9
Oceania[a]	3	1	3	1
Europe	4	5	4	2
Total	100	100	100	100

SOURCE: Congressional Budget Office based on data from the Organization for Economic Cooperation and Development.

NOTE: Official development finance includes official development assistance (grants and concessional loans) as well as nonconcessional loans or credits from individual countries and multilateral organizations. Data reflect gross flows expressed as a four-year average, 1989-1992.

a. Pacific island states.

receive more than half of all FDI to the developing world. Most of those countries had vigorous economic growth rates between 1990 and 1994, and all except China are middle-income or upper-middle-income countries. According to the OECD, the increase in FDI to developing countries since the mid-1980s reflects the progress that those countries have made in liberalizing trade regimes and large-scale privatization of state-supported industries.

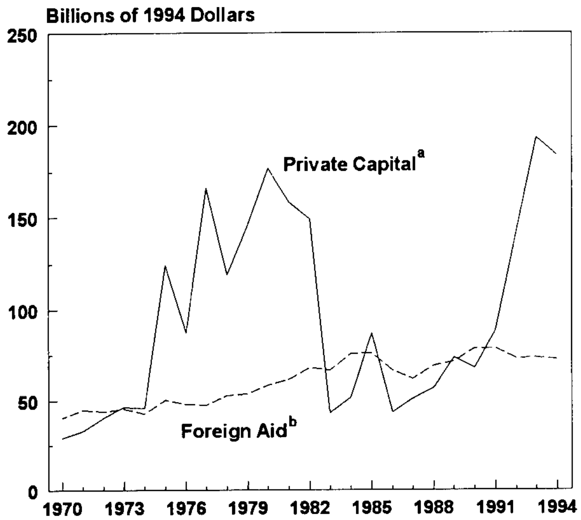
Other private capital includes long- and short-term loans by commercial banks, bonds, and equity flows (investment in the stock markets of developing countries). Compared with FDI, equity flows have tended to be more volatile, rising or falling with conditions on the international market. For example, the Mexican peso crisis in 1994 led to a substantial drop in money being invested in the stock markets of developing countries, but FDI still grew by more than $10 billion in that year. Lending by commercial banks decreased in 1993 but turned positive again in 1994 and 1995. Investment in bonds issued by developing countries, however, held steady between 1993 and 1995.

An important question that has arisen in the literature is whether foreign assistance serves as a catalyst for private capital flows. Theoretically, it might, because foreign economic assistance, particularly that from multilateral institutions, would indicate which countries have economic policies conducive to growth or are implementing such policies. Alternatively, aid might assist developing countries in achieving policy reform and a higher income status. Thus, private capital would know where investment was likely to be the most profitable. In practice, however, the data supporting such a relationship are inconclusive. One study, for example, found a positive relationship between bilateral aid and private capital flows and a negative but insignificant one between multilateral aid and private capital.[10] That analysis has been criticized for failing to distinguish between multilateral lending directed toward public goods, which may have a positive association, and multilateral lending for emergencies, which may discourage private capital flows.[11]

10. Dani Rodrik, "Why Is There Multilateral Lending?" in Michael Bruno and Boris Pleskovic, eds., *Annual World Bank Conference on Development Economics 1995* (Washington, D.C.: World Bank, 1996), pp. 167-193.

11. Guillermo A. Caluo, "Comment on 'Why Is There Multilateral Lending?' by Dani Rodrik," in Michael Bruno and Boris Pleskovic, eds., *Annual World Bank Conference on Development Economics 1995* (Washington, D.C.: World Bank, 1996), pp. 194-196.

Figure 3.
Volume of Private Capital and Foreign Aid to All Developing Countries



SOURCE: Congressional Budget Office based on data from the Organization for Economic Cooperation and Development and the World Bank.

a. Includes short- and long-term net flows.

b. Represents net official development finance.

The prospects for the continued long-term growth of private capital to developing countries are promising, although short-term volatility in the amount of investment will probably continue. Developing countries seem to realize in increasing numbers that the more they liberalize trade, privatize state industry, and adopt open, market-oriented economic policies that encourage integration in the world economy, the more likely they are to see sustained economic growth. Such conditions tend to attract private capital, particularly FDI and investment in stock markets.

Chapter Three

Development and the Role of Foreign Aid

Successful long-term development is a complex process that depends on many factors. The Congressional Budget Office's review of the development literature identified two themes that seem particularly important: the quality of governance in a country will heavily influence its development; and adopting economic policies that promote growth will contribute significantly to development.

Compared with those two factors, foreign aid is much less important in determining whether a country will achieve long-term economic growth and development. However, foreign aid is likely to be the most helpful when it is given to countries that maintain stable, honest governments and have adopted market-oriented, outward-looking economic policies. Foreign aid can encourage countries to adopt positive political and economic policies if that is its principal objective. But it may undermine development if it is given to countries that are unlikely or unwilling to make necessary political and economic reforms.

The Influence of Governance on Development

CBO's review of the development literature suggests that the way a country is governed will affect its rate of development. Three characteristics seem key:

- Countries that have enjoyed a high measure of political stability and social order are more likely to develop than countries that have experienced instability and chaos.

- The less self-serving the officials of a developing country's government, the more likely that country is to achieve long-term development.

- Successful development usually depends on the existence of functioning governmental institutions that can support a growing economy.

Political Stability

Political instability, not surprisingly, is likely to hinder development. Studies have shown that countries in which political authority has broken down—perhaps even to the point where civil war erupts—are less likely to achieve economic growth and improvements in human welfare.[1] Instability, especially civil war, may cause widespread destruction of private and public property. It is likely to impede productive activities by raising the economic risk that potential investors face. Countries such as Ethiopia, Rwanda, Somalia, and

1. See N. Gregory Mankiw, "The Growth of Nations," *Brookings Papers on Economic Activity*, no. 1 (1995). See also Pierre-Richard Agenor and Peter J. Montiel, *Development Macroeconomics* (Princeton: Princeton University Press, 1996), pp. 30-32.

Liberia—all of whom have experienced lengthy or intense civil wars—were unable to achieve any lasting economic development while those conflicts raged. In contrast, countries that have smoothly functioning and stable political systems tend to be more capable of pursuing a program of development.

Honest and Capable Administration

Honest and capable government appears to be an important component of development. In its absence, government officials may pursue policies that damage the economy simply because those policies benefit them and others with political and economic power. When governments require permits, licenses, and quotas that effectively create private monopolies throughout the economy, they essentially lower economic output and raise prices. Governments can also increase waste through uncompetitive contracting that favors the politically well connected rather than the most innovative or efficient. The government may charge explicitly for the monopoly or contracting privileges it grants. Moreover, government officials may take bribes and kickbacks or even misappropriate funds to their own accounts. In either case, the resource represented by the labor of a government employee is not contributing to the economy's productive capacity; even worse, it is creating inefficiency elsewhere in the economy.[2]

Governmental Institutions and Public Goods

Some experts argue that governmental institutions that can support economic activity are important to development. Those institutions can be classified as two different types: the laws, regulations, and other rules that foster economic activity; and formal organizations such as a central bank.

The first type of institution usually includes mechanisms that protect property rights, make and enforce contracts, organize a system of national currency, create a system of tax collection, or provide the regulatory framework for things like a banking system or stock exchange. They are the "rules of the game"—the institutions that make the economic system less arbitrary, lower the economic risk in investing in productive activities, and facilitate economic interaction. Assuming they are properly constructed, they reduce the transaction costs of economic activity.[3]

The second type are the institutions most people usually think of—formal organizations. Some of them implement the system of laws discussed above, such as a police force and an independent judicial system. In countries that lack an impartial judicial system, potential entrepreneurs—foreign or domestic—are likely to be discouraged from starting businesses or expanding existing ones. Such institutions also include financial organizations—a central bank, for example.[4] Most developing countries have such organizations today, but as late as the 1970s, not all did. Even a uniform language is an innovation that may promote development by making it easier for people to engage in commerce, although some multilingual countries, such as Switzerland, have achieved impressive levels of economic prosperity.

An important function of those organizations is the provision of public goods. Such goods are used by most or all members of a society but are unlikely to be provided by any one individual, because everyone would reap the benefit of that good but the individual would have assumed all of its cost. They may also be goods that are simply too expensive for one person or group to provide and then expect a reasonable rate of return. Ports, roads, communication systems, and irrigation systems are examples of such public goods.[5] That kind of physical infrastructure is crucial to a country's long-term development.

Providing a system of education through at least the elementary school level is perhaps the most important public investment a government can make to improve human resources. A basic level of education is neces-

2. See, for example, World Bank, *World Development Report 1987* (New York: Oxford University Press, 1987), pp. 74-77.

3. A country may, of course, have written its laws on banking or property rights so badly that they inhibit economic growth more than if those laws did not exist at all.

4. For a general discussion of the importance of institutions, see World Bank, *World Development Report 1991: The Challenge of Development* (New York: Oxford University Press, 1991), pp. 134-136.

5. A judicial system and a finance ministry are also public goods, but they in turn provide additional public goods that are discussed here.

Table 6.
Economic Rates of Return in Education
(In percent)

Country Group	Rate of Return by Average Level of Education		
	Primary	Secondary	Higher
Industrial Market Economies[a]	15	11	11
Developing Country Exporters of Manufactured Goods[b]	15	13	9
Other Developing Countries[c]	28	17	14

SOURCE: World Bank, *World Development Report 1987* (New York: Oxford University Press, 1987), Table 4.1.

NOTE: The economic rates of return (referred to as social rates of return in the literature on the economics of education) on which the averages are based are from studies that for the most part refer to the 1970s and early 1980s. For comparison, economic rates of return to investment in physical capital averaged 13 percent for developing countries and 11 percent for industrial market economies.

a. The lack of a control group of illiterates in the industrial market economies prevents a direct computation. The estimates are based on the return for developing countries that export manufactured goods.

b. India, Israel, Singapore, and Yugoslavia.

c. Twenty-six countries.

sary to have a productive labor force. For example, many countries in East Asia invested heavily in education and achieved above-average economic growth rates over the past 20 years. In addition, investment in education (and health) spread the benefits of that economic growth across those countries—the rich became richer, but the poor became richer as well. According to a study by the World Bank, the economic rate of return for primary education in developing countries is almost double that in industrial market economies (see Table 6).[6]

6. World Bank, *World Development Report 1987*. Just as the rate of return on traditional investment measures the economic benefits of that investment relative to its cost, the rate of return on education measures the gains in income realized by those who attain particular levels of education.

Does Democracy Matter?

Experts on development cannot agree on whether democracy promotes development. Some aid-giving organizations, such as the Agency for International Development, argue that promoting democracy in recipient countries will reduce corruption and foster development. For example, AID's annual report states that "democracy is not only an end in itself, but it makes a vital contribution to sustainable development."[7] Democracy, in that view, enhances the protection of human rights, increases public accountability, frees individual initiative, and facilitates informed participation of the citizenry in the process of government and development.

No firm empirical link exists, however, between democracy and the rate of economic growth. Different regions seem to yield different results. In the Far East, many countries that have been less than democratic have experienced exceptional economic performance. In Africa, many authoritarian states have performed much worse than Botswana, a democracy since gaining its independence in 1966. Certainly among the developed countries, democracies have outshone dictatorships in terms of growth and development.[8]

To help sort out the issue, Jagdish Bhagwati created four categories of governance and market orientation into which most countries fall:

- Democracies with markets have had good economic performance and strong social indicators. Most Western countries are in this category.

- Democracies without markets have had poor economic performance and weak social indicators. India has been the classic example.

- Authoritarian governments without markets have failed in terms of economic growth and social indicators. The former socialist countries of the Soviet bloc are obvious illustrations.

7. Agency for International Development, *Annual Report on Program Performance 1994* (March 1995), p. 19.

8. For a balanced discussion of this issue, see World Bank, *World Development Report 1991*, pp. 132-134.

- Authoritarian governments with markets have made rapid gains in prosperity. Examples include China, the fast-growing countries of East Asia, and Chile under General Pinochet.

Bhagwati's categorization suggests that market liberalization has been a very strong determinant of growth and that democracy may facilitate growth; without strong markets, however, democracy will not be able to sustain growth.[9]

The Influence of Domestic Economic Policy on Development

The development literature argues that the economic policy environment is crucial to long-term development. At the most basic level, of course, countries need to have a market-oriented economy dominated by a private sector. Beyond that, sound economic management of that economy and an outward-oriented trade and industrialization strategy are essential components of successful long-term development.

Monetary and Fiscal Policy

Experts generally agree that a country's economic policies play an extremely important role in its development. In the long run, economic growth depends on the growth of physical and human capital and their productivity. Physical capital is largely a country's infrastructure—roads, bridges, canals, irrigation systems, communication networks, and the like. Human capital is the health and education of a country's population.

The growth of a country's human capital is largely determined by the growth of its population and skills base, and that of its physical capital by the country's rate of net saving. Noninflationary monetary policies and low budget deficits provide a favorable environment for saving and for accumulating capital, whereas large deficits, high inflation, and the resulting financial instability work against them. The factors that determine productivity are not well understood, but other aspects of economic policy can affect the ability of an economy to deploy resources productively. Policies that create uncertainty or that otherwise harm the incentives for saving and investing and for accumulating physical and human capital will inhibit development and economic growth.[10]

Uncontrolled fiscal policies, according to development economists, have been at the center of the economic problems of many developing countries in which an ill-disciplined public sector has diverted resources from the private economy. Spending on large government payrolls, government industries that are inefficiently run, and various subsidy programs (for the population as a whole, for specific economic sectors, or for individual industries) have created large fiscal deficits in many developing countries. For example, before the economic reform program under President Carlos Menem, Argentina had high government budget deficits that were caused in part by large annual losses in more than 300 state-owned enterprises.[11]

A common means of financing the resulting government deficits has been to expand the money supply. But doing so has led in turn to inflation and ultimately—if the country has fixed nominal exchange rates and an overvalued currency in inflation-adjusted terms—to shortages in foreign exchange. Foreign investors may be reluctant to lend to such an economy, and the foreign currency reserves required to maintain a fixed exchange rate may run out.

Many governments have tried to regulate and control the operation of private markets in ways that have further distorted the incentives for private economic production and investment. Setting price controls, granting monopolies, and subsidizing particular producers are all ways in which governments have wasted resources by overriding the functioning of the market. Controls on interest rates and capital flows and the rationing of foreign exchange become necessary when a government tries to isolate its domestic economy from the powerful market forces of the world economy. As

9. Jagdish Bhagwati, "New Thinking on Development," *Journal of Democracy*, vol. 6 (October 1995), pp. 61-62.

10. World Bank, *World Development Report 1991*, pp. 109-127.

11. Anne O. Krueger, Constantine Michalopoulos, and Vernon W. Ruttan, eds., *Aid and Development* (Baltimore: Johns Hopkins University Press, 1989), p. 56.

markets are controlled and suppressed, prices become distorted, inhibiting the effective and efficient use of society's resources. Some analysts have found that the greater the restrictions on interest rates, the lower the economic growth. Other common distortions include having minimum-wage laws, placing limits on laying off workers, and setting public-sector wages above those of the private sector for comparable jobs.[12]

Trade and Industrialization Policy

The extent of a country's openness and integration in the world economy and trading system is also important to development. The discipline of world market prices makes it much harder to sustain distortionary domestic policies that might divert the economy's resources to wasteful and inefficient uses. Substantial evidence indicates that the more a country adopts a generally outward-looking economic policy, the more likely it is to experience sustained economic growth and improved social welfare.

Two primary strategies for becoming industrialized directly involve trade policies: inward-looking import substitution and outward-looking export-led growth. This discussion relies on the following factors to distinguish between those two strategies:[13]

- *Degree of trade protection.* The lower the actual protection for domestic markets, the more trade policy is export-oriented. Policies that contribute to the effective rate of protection include tariffs and nontariff barriers as well as taxes and subsidies for inputs, such as energy or steel, that are used to make particular products.

- *Use of direct controls such as quotas and import licensing.* The less a country relies on direct controls on imports, the more outward-oriented the economy.

- *Use of export incentives.* The greater the use of broad-based export subsidies and incentives, the more export-led and outward-oriented the economy.

- *Degree of overvaluation of the exchange rate.* Outward orientation generally reflects an appropriately valued exchange rate.

Import Substitution. When policymakers pursue an import-substitution strategy, they adopt policies to encourage the domestic production of as many industrial goods as possible. They may place high tariffs on imports and grant credits or exemptions from import taxes to producers of particular goods. Such policies protect industries from international competition and encourage the production of items at home that would otherwise have been imported in the absence of subsidies and trade restrictions.

The motivation for this strategy is understandable. Many developing countries recognize that the path to greater prosperity is through industrialization. But new industries in developing countries find it very difficult to compete with established producers from the more advanced economies unless they have some sort of protection or subsidy. Indeed, the United States and Germany used the strategy of protecting new industries in the late 1800s to develop their industrial sector in the face of competition from more established and advanced companies in Great Britain, the first nation to industrialize.

This strategy initially may spur industrialization and economic growth, but unless the trade tariffs and subsidies are gradually removed, the protected industries are likely to become increasingly less efficient over time because they have little competition. Productivity, competitiveness, and growth in export earnings slow down or decline, possibly creating or exacerbating fiscal deficits and other economic problems.

The practice of import substitution has led many developing countries to set up government-run enterprises or to nationalize industry so that they can produce goods directly. They may also use autonomous institutions to regulate and supervise an entire industrial sector. Those organizations or enterprises may be poorly run and highly susceptible to corruption. The government may strangle domestic competition through

12. Ibid., pp. 58-59.

13. World Bank, *World Development Report 1987*, p. 82.

overregulation or by restricting access to credit. In addition, the government-run enterprises and autonomous institutions may create new interest groups that demand government support and protection from external competitors.

The consequences of such inward-looking economic policies are considerable. Protection removes much of the incentive for companies to produce more efficiently and competitively, which tends to result in goods of inferior quality produced at high costs. Policymakers often maintain a policy of fixed exchange rates; as domestic prices increase faster than international prices, the currency becomes overvalued. That result in turn may lead to more protection in an attempt to promote growth at home and to restrict domestic demand for imports. Public spending to stimulate development, which can occur simultaneously, also increases demand for imports and, thus, the pressure for more protection. Even industries that should be competitive in world markets may become uncompetitive because protection eliminates or reduces the incentive for efficiency.

Export-Led Growth. The second strategy is outward-oriented, export-led growth, which usually involves specializing in a more limited range of products. Exchange rate policy is neutral with respect to exports, and the government may use broad-based tax rebates or access to credit to promote exports. This strategy also encourages domestic companies to produce efficiently by forcing them to compete with one another for international markets.

Many countries in East and South Asia have generally followed an outward-oriented strategy and have experienced high rates of economic growth. Countries such as South Korea, Taiwan, and Singapore as well as Thailand, Malaysia, and even Indonesia protected domestic producers for a short time and then gradually allowed more imports to subject the home-grown industries to competitive pressures. They also encouraged saving, invested in education, and maintained conservative fiscal policies.

Studies have shown that countries that adopt an outward-oriented trade and economic strategy as well as policies that have a minimal distorting effect on the economy achieve higher growth rates than inward-looking countries. Jeffrey Sachs and Andrew Warner found that developing countries with open economies grew at an average annual rate of 4.5 percent between 1970 and 1989 compared with only 0.7 percent for those with closed economies.[14]

The World Bank came to a similar conclusion in its 1987 *World Development Report*. It classified 41 developing countries into four categories: strongly outward-oriented; moderately outward-oriented; moderately inward-oriented; and strongly inward-oriented (see Table 7). The bank found that an outward orientation was positively related to higher growth rates for real gross domestic product (GDP), higher real gross national product per capita, more productive investment as represented by the incremental ratio of capital to output, and higher rates of growth in manufactured exports (see Figure 4). The bank concluded that "the economic performance of the outward-oriented economies has been broadly superior to that of the inward-oriented economies in almost all respects."[15]

The Role of Foreign Aid in Development

The literature that has evaluated the role of foreign aid in development falls into two broad categories. A substantial empirical literature attempts to analyze the effects of foreign aid on economic growth using statistical models and aggregate data on economic and foreign aid for large numbers of countries. A second body of literature attempts to understand the role of foreign aid in development in a more qualitative fashion, relying on in-depth research or case studies of particular foreign aid programs. The empirical literature thus far is inconclusive. The qualitative literature generally argues that foreign aid can help development if the policy environment is favorable to growth.

14. Jeffrey D. Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, no. 1 (1995), p. 36.

15. World Bank, *World Development Report 1987*, p. 85.

Table 7.
Classification of 41 Developing Economies by Trade Orientation, 1963-1973 and 1973-1985

Period	Strongly Outward-Oriented	Moderately Outward-Oriented	Moderately Inward-Oriented	Strongly Inward-Oriented
1963-1973	Hong Kong South Korea Singapore	Brazil Cameroon Colombia Costa Rica Côte d'Ivoire Guatemala Indonesia Israel Malaysia Thailand	Bolivia El Salvador Honduras Kenya Madagascar Mexico Nicaragua Nigeria Philippines Senegal Tunisia Yugoslavia	Argentina Bangladesh Burundi Chile Dominican Republic Ethiopia Ghana India Pakistan Peru Sri Lanka Sudan Tanzania Turkey Uruguay Zambia
1973-1985	Hong Kong South Korea Singapore	Brazil Chile Israel Malaysia Thailand Tunisia Turkey Uruguay	Cameroon Colombia Costa Rica Côte d'Ivoire El Salvador Guatemala Honduras Indonesia Kenya Mexico Nicaragua Pakistan Philippines Senegal Sri Lanka Yugoslavia	Argentina Bangladesh Bolivia Burundi Dominican Republic Ethiopia Ghana India Madagascar Nigeria Peru Sudan Tanzania Zambia

SOURCE: Congressional Budget Office using data from World Bank, *World Development Report 1987* (New York: Oxford University Press, 1987).

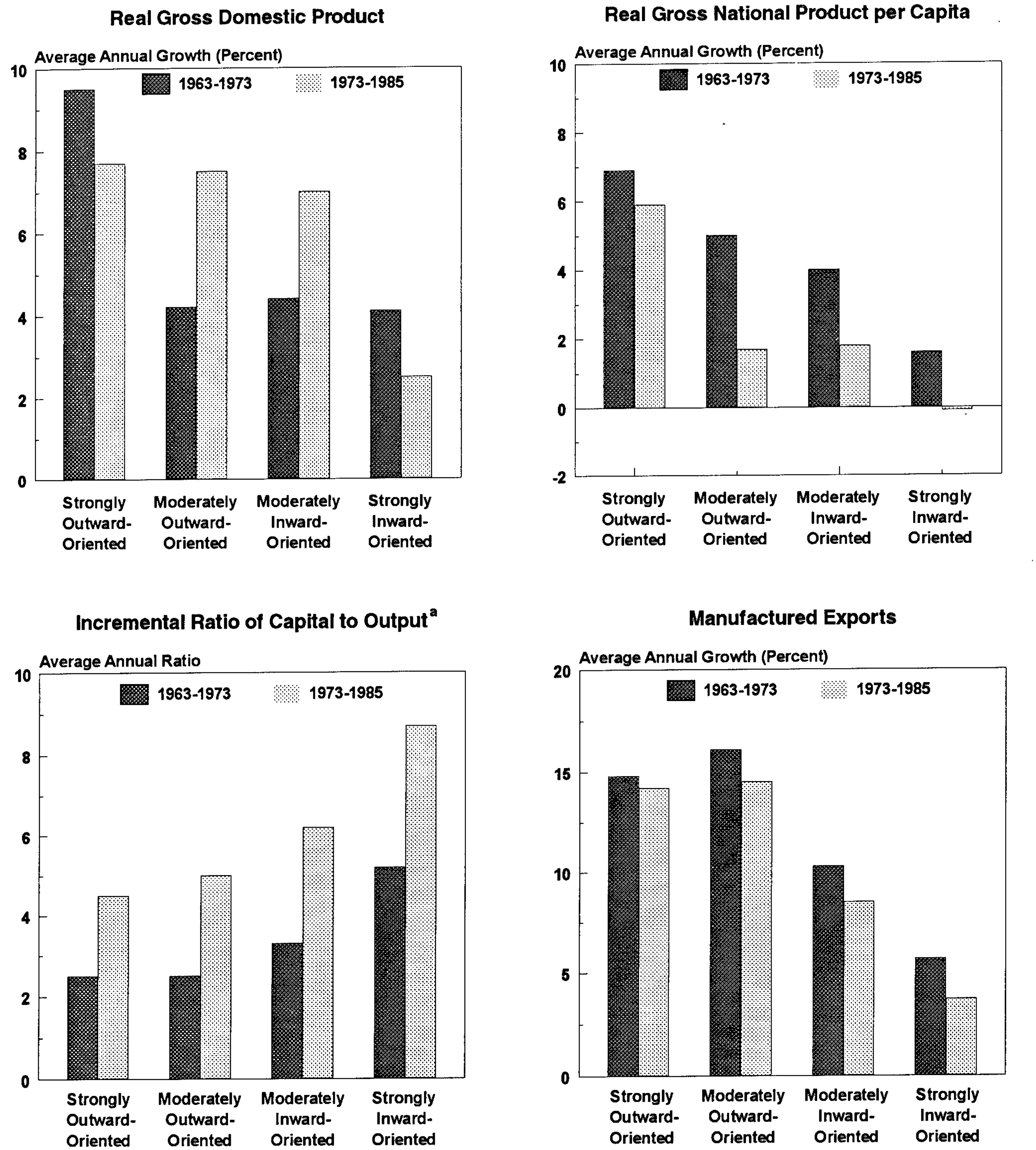
NOTES: *Strongly Outward-Oriented*: Trade controls are nonexistent or very low; disincentives to export resulting from import barriers are more or less counterbalanced by incentives to export. There is little or no use of direct controls and licensing agreements, and the exchange rate is maintained such that the effective exchange rates for imports and exports are roughly equal.

Moderately Outward-Oriented: The overall incentive structure is biased toward production for domestic rather than export markets. But the average rate of effective protection for the home markets is relatively low, and the range of effective protection rates is relatively narrow. The use of direct controls and licensing arrangements is limited, and although some direct incentives to export may be provided, they do not offset protection against imports. The effective exchange rate is higher for imports than for exports, but only slightly.

Moderately Inward-Oriented: The overall incentive structure distinctly favors production for the domestic market. The average rate of effective protection for home markets is relatively high, and the range of effective protection rates is relatively wide. The use of direct controls on imports and licensing is extensive. Although some direct incentives to export may be provided, there is a distinct bias against exports, and the exchange rate is clearly overvalued.

Strongly Inward-Oriented: The overall incentive structure favors production for the domestic market. The average rate of effective protection for home markets is high, and the range of effective protection rates is relatively wide. The use of direct controls on imports and licensing disincentives to the traditional export sector is pervasive, positive incentives to nontraditional exports are few or nonexistent, and the exchange rate is significantly overvalued.

Figure 4.
Performance of 41 Developing Economies Grouped by Trade Orientation



SOURCE: Congressional Budget Office based on data from World Bank, *World Development Report 1987* (New York: Oxford University Press, 1987).

NOTE: Averages are weighted by each country's share in the group total for each indicator. See Table 7 for a list of the economies in each of the trade groups.

a. For the incremental ratio of capital to output, the lowest value indicates the most productive investment.

Evidence from Statistical Studies

Ever since the pathbreaking analysis by Hollis Chenery and Alan Strout, there has been considerable interest in what might be called the econometrics of foreign aid. Those authors developed the "two-gap" model of development.[16] According to that model, to achieve a given growth rate, a developing country must have adequate savings for investment and sufficient foreign exchange to buy the capital goods necessary for development from the international market. If a country is deficient in either area, then foreign aid can fill the gap either by providing foreign saving to supplement inadequate domestic saving or by providing the necessary foreign exchange to buy the goods and services in the international market that the country requires for development but cannot produce on its own. Thus, by specifying a particular growth rate and holding productivity constant, one can determine the amount of aid needed to achieve that growth by subtracting the domestic saving rate from the growth rate or subtracting export earnings from import requirements. The larger of the two gaps is the amount of foreign aid the country needs to achieve the given growth rate. Foreign aid will "fill two gaps at once" because foreign aid provided as foreign exchange can be used to buy imported capital goods and can supplement domestic saving directly.

Chenery and Strout analyzed data for 50 developing nations. For each country, they measured the growth rate of GNP, the rate of investment, the rate of domestic saving, and the propensity to export and import. Using those values, they identified countries that were likely to benefit from an infusion of external resources because their own saving were inadequate, as well as others for which greater aid might be of limited value. But Chenery and Strout assumed that foreign assistance would be productive if inadequate saving or foreign exchange was the constraint on growth.

A number of other economists have attempted to measure statistically the extent to which foreign aid encourages economic development. Two separate, though related, issues are of interest to analysts and policymakers: Do the projects funded through foreign assistance programs yield a positive economic return, and do the projects achieve the objective set for them? To explore the first issue, the multilateral lending agencies, for example, regularly assess the returns on the projects funded by their loans and periodically compile them into an overall assessment of effectiveness. According to their analyses, foreign aid projects, as a whole, appear to yield favorable rates of return. A 1995 study by the World Bank found an average rate of return of 17 percent on projects completed between 1990 and 1994. Assessments by the Asian Development Bank and the Inter-American Development Bank have yielded similar results. To determine whether projects achieve their objectives—for example, the construction of a road or hospital—a team of researchers reviewed project evaluations from the early 1980s. They concluded that projects, on average, produce satisfactory results. As evidence, they cited the findings of eight major agencies that had evaluated a large number of their projects. Their evaluations indicated that two-thirds to three-quarters of the projects broadly achieved their objectives.[17]

Not all analysts would accept project results as definitive proof of the effectiveness of aid. Project evaluations, though useful in judging the performance of lending institutions and their staffs, do not capture the overall economic effects of aid, whether positive or negative. Proponents of aid might argue that the transfer of technology and knowledge that accompanies many major aid efforts could have important spillover benefits that the agencies' assessments do not capture. For instance, a major construction project may equip workers with skills that they will retain and continue to use after that particular project is completed. Conversely, the construction of a dam to generate hydroelectric power may succeed in the sense that electricity is produced, but it may have disastrous environmental consequences for the neighboring villages, wildlife, and other natural resources.

Critics of foreign assistance argue, however, that the receipt of such aid discourages domestic saving. They believe that projects that represent good investment opportunities will be financed in any event using private foreign or domestic funding. The receipt of foreign assistance may simply divert those funds into con-

16. H.B. Chenery and A.M. Strout, "Foreign Assistance and Economic Development," *American Economic Review*, vol. 56 (September 1966), pp. 679-733.

17. Robert Cassen and others, *Does Aid Work? Report to an Intergovernmental Task Force* (Oxford: Clarendon Press, 1986), p. 307.

sumption, for no net gain in total domestic investment activity.

For those reasons—and also because aggregate national data are more accessible to the academic scholar than are project data—most empirical studies of development have attempted to determine whether receiving foreign assistance can be shown to be positively related to higher rates of national saving, capital formation, or economic growth. A typical study would gather aggregate national statistics for those variables for some 50 to 100 developing countries. Data would be in the form of annual averages for growth rates, saving rates, and inflows of aid and foreign investment. Data are expressed as a percentage of GDP to avoid weighting the larger nations more heavily in the results.

The results of such studies are far less definitive than were analyses of large numbers of project evaluations. If aid does not add significantly to total national saving, it is not likely to promote growth. Early studies, confirmed by more recent investigations, found that foreign assistance contributed little, if any, impetus to saving and instead increased domestic consumption.

Table 8.
Selected Studies Examining the Correlation of Aid with National Saving, Capital Formation, and Economic Growth

Study	Conclusions
Griffin and Enos (1970)[a]	Aid receipts appear to reduce domestic saving; thus, they do not add to investment.
Weisskopf (1972)[b]	The inflow of foreign capital has a significantly negative impact on domestic saving.
Papanek (1972)[c]	Omitted factors that produce below-average saving rates will produce above-average foreign inflows. That biases the relationship between aid and saving.
Heller (1975)[d]	A positive and significant relationship exists between foreign aid and investment.
Mosley (1987)[e]	No significant correlation exists between aid and growth once other factors such as private capital flows and domestic saving are taken into account.
Boone (1996)[f]	No significant correlation exists between aid and growth. Virtually all aid goes to consumption.

SOURCE: Congressional Budget Office using sources listed below.

a. Keith L. Griffin and J.L. Enos, "Foreign Assistance: Objectives and Consequences," *Economic Development and Cultural Change*, vol. 18 (April 1970), pp. 313-337, as cited in Anne O. Krueger, Constantine Michalopoulos, and Vernon W. Ruttan, eds., *Aid and Development* (Baltimore: Johns Hopkins University Press, 1989), Chapter 7.

b. Thomas E. Weisskopf, "The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," *Journal of International Economics*, vol. 2 (February 1972), pp. 25-38.

c. Gustav F. Papanek, "The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries," *Economic Journal*, vol. 82 (September 1972), pp. 934-950, as cited in Anne O. Krueger, Constantine Michalopoulos, and Vernon W. Ruttan, eds., *Aid and Development* (Baltimore: Johns Hopkins University Press, 1989), p. 120.

d. Peter S. Heller, "A Model of Public Fiscal Behavior in Developing Countries: Aid, Investment, and Taxation," *American Economic Review*, vol. 65 (June 1975), pp. 429-445. The analysis employed a multiequation model.

e. Paul Mosley, *Overseas Aid: Its Defence and Reform* (Brighton, England: Wheatsheaf Books, 1987), Chapter 5.

f. Peter Boone, "Politics and the Effectiveness of Foreign Aid," *European Economic Review*, vol. 40 (1996), pp. 289-329.

One reason could be that for most countries, aid flows are simply too small to make a difference in overall national saving rates (see Table 8 for a summary of major studies since 1970).

Such a conclusion is not inconsistent with the broader aims of foreign assistance programs—improving the health and welfare of the population, promoting democracy, and so forth. But it is inconsistent with the narrower proposition that receipt of aid promotes economic growth. Although the majority of studies have failed to find a link between aid and economic growth, some analysts have obtained more positive results. In particular, a positive correlation between aid, saving, and growth has been established for the group of developing countries in Asia. The overall negative findings can be attributed mainly to the failure of aid to countries in Africa to improve their economies.

Gustav Papanek attributes the negative results of studies of foreign aid to statistical biases. In particular, the fact that aid is targeted toward the poorer nations might bias downward the measured correlation between saving or growth rates and the amount of aid received. Using more complex models, some analysts found a positive and significant relationship between the formation of capital and public and private investment flows.

In a recent article, N. Gregory Mankiw of Harvard University, after examining empirical models of nations' growth, suggested that the roughly 100 nations for which data on economic performance over recent decades are available offer too few observations to allow scholars to discriminate among the many factors said to contribute to growth, notably including foreign aid.[18] According to Mankiw, the empirical evidence from this body of research is simply too limited to enable analysts to reach strong conclusions.

Evidence from Qualitative Studies

CBO found that the qualitative literature on foreign aid and development strongly suggests that the usefulness of development assistance varies with the quality of a country's governance and the economic policies it pursues. In countries whose policy environment is highly unfavorable to growth, aid is less likely to be productive and contribute to long-term development. According to one group of scholars, "in terms of growth prospects and performance, no amount of foreign assistance can substitute for a developing country's internal policies and incentives for increasing output and improving the efficiency of resource allocation."[19] Development assistance has enabled some countries whose policy environment was not quite as severe to achieve temporarily higher rates of growth than if they had not received aid at all. Although foreign aid may allow developing countries to postpone correcting their economic policies, it may also encourage them to adopt needed economic reforms. Finally, foreign assistance can help strengthen development in countries whose policies do not distort the allocation of resources in the economy.[20]

Studies by the World Bank have tended to confirm those broad conclusions. In its 1991 *World Development Report*, the bank found decreasing rates of return for its aid projects as the overall policy environment deteriorated along various economic indicators (see Table 9). And the World Bank's Wapenhans Report —an extensive inquiry into the effective implementation of aid projects—noted that its "findings support the need for linking strategy, especially in social sectors, even at the project level, to the overall framework of policies at the country level. Even very well designed projects cannot succeed in a poor policy or regulatory environment."[21]

Policy Dialogue and Conditionality. In light of the crucial importance of governance and economic policies, foreign aid may be able to help developing countries make appropriate political and economic reforms. Donors can encourage policy reform through two primary means: policy dialogue (donors give aid to create opportunities for policy discussions and interactions with the recipient on key issues such as macroeconomic policy) and conditionality (donors release the aid only if recipients meet certain economic criteria, such as reducing fiscal deficits below certain levels or reducing tar-

18. Mankiw, "The Growth of Nations."

19. Krueger, Michalopoulos, and Ruttan, *Aid and Development*, p. 89.

20. Ibid., pp. 60-62.

21. Portfolio Management Task Force, *Effective Implementation: Key to Development Impact* (Washington, D.C.: World Bank, September 1992), p. 7.

iffs by a particular percentage within a specified time frame).

In practice, policy dialogue and conditionality are often two sides of the same coin. In the background of even the most benign policy dialogue is the mutual understanding between donor and recipient that aid can be terminated at any time, even if that is unlikely. Yet conditionality in the absence of dialogue is unlikely to occur and is probably too blunt an instrument for achieving the desired objectives of reform. Thus, many aid relationships involve some element of both policy dialogue and conditionality—if policy reform and development are the objectives of the aid—but the balance between the two varies from country to country and donor to donor.

The record on the effectiveness of policy dialogue and conditionality is mixed. In the 1950s and 1960s, for example, U.S. aid to some Asian countries involved both policy dialogue and elements of conditionality. That approach yielded some positive results in South Korea and Taiwan but was much less successful in India.

Table 9.
Rates of Return on Successful Aid Projects Financed by the World Bank, 1968-1989, by Policy Environment of Recipient Countries (In percent)

Policy and Level of Distortion in Recipient Countries	Rates of Return
Trade Restrictiveness	
High	13.2
Moderate	15.0
Low	19.0
Foreign Exchange Premium	
High (200 percent or more)	8.2
Moderate (20 percent to 200 percent)	14.4
Low (Less than 20 percent)	17.7
Real Interest Rate	
Negative	15.0
Positive	17.3
Fiscal Deficit as a Percentage of Gross Domestic Product	
High (8 percent or more)	13.4
Moderate (4 percent to 8 percent)	14.8
Low (Less than 4 percent)	17.8

SOURCE: Congressional Budget Office based on data from the World Bank, *World Development Report 1991: The Challenge of Development* (New York: Oxford University Press, 1991), p. 82.

More recently, multilateral institutions, particularly the World Bank, have used both tools to encourage recipients to make macroeconomic reforms, and those efforts have also had mixed results. The main mechanism they use is known as structural adjustment lending, a process by which donors make loans to recipients in successive tranches as policy reforms are carried out. Those reforms are usually negotiated between donors and recipients. How successful those efforts have been, however, is not clear.

Policy dialogue and conditionality have perhaps been most effective when recipients knew they had to make reforms and wanted to make them but needed some extra political cover to do so. Such economic reforms as cutting government spending, reducing subsidies, and lifting trade barriers are inherently unpopular because they take benefits away from some groups —and in some cases, politically powerful ones. Under those circumstances, foreign aid may lend credibility to a reform effort and soften the negative consequences such reforms may have. More specifically, officials in the recipient country may have realized that such reforms are necessary—either through a dialogue with donors or on their own—but would like the presence of "conditions" so that the onus of making such unpopular changes is shifted to a foreign entity, thereby reducing the political pressure on themselves. According to some scholars, cases of such "phantom" leverage are quite common.[22]

Increasing Resources for Investment. The main macroeconomic mechanism by which aid can promote growth is to enlarge the pool of capital available for investment and growth. Even in a favorable policy environment, however, foreign aid may permit domestic resources to be diverted from investment to consumption, with no net effect on growth. Empirical studies of this issue, as was indicated earlier, have yielded inconclusive results. Studies of individual countries are

22. Krueger, Michalopoulos, and Ruttan, *Aid and Development*, p. 91.

equally inconclusive: aid seems to contribute to saving in some cases but not in others.[23]

Providing Public Goods. Foreign aid might help raise the level of investment in the economy by easing the constraints on public funds available for necessary public investments—that is, goods that are important for production and for which the returns cannot be captured and used to repay borrowing; public investments may include infrastructure such as rural roads. Foreign aid might also limit the strains on the domestic tax base and prevent costly distortions. For example, the recipient might levy tariffs to fund those public investments if it does not receive aid.

According to the Agency for International Development, the success of foreign aid in supporting public investment also varies widely. The Inter-American Highway in Central America was funded largely through foreign aid (though it was not called that at the time), and it has contributed enormously to improving the prospects of growth for Central American countries. But such projects have also failed. Many aid-financed projects languished after their completion, because the recipient government was unwilling or unable to provide adequate maintenance.

Increasing Human Capital. Foreign aid might be able to help a country develop its human capital—for example, by supporting elementary education or basic health care. Investment in human capital in developing countries is often more difficult to finance than are physical capital projects. Even in relatively rich countries, private investors are wary of lending for skills and education without a government guarantee for a return on investment. Foreign aid, however, may be able to provide targeted funds for enhancing human capital and thereby raise the economy's stock of skills and, perhaps, stimulate growth.

Foreign aid can claim some credit in this area. Aid resources have helped strengthen agricultural production by funding new crop varieties, irrigation programs, and extension practices. They have also played a role in sponsoring research, education, and immunization programs that have led to the control of various diseases such as smallpox, polio, diphtheria, and measles.

23. Cassen and others, *Does Aid Work?* p. 24.

But simply investing more in physical or human capital will not necessarily lead to fast economic growth. Many countries have invested heavily over long periods but have not grown quickly.[24] Productive investment in human—as well as physical—capital still depends on the policy environment. In the words of the 1995 *World Development Report*, "Greater investment in human capital can neither compensate for nor overcome an environment inimical to economic growth."[25]

In addition, the particular investment choices also matter. For example, the World Bank argues that excessive spending on education bureaucracy and school infrastructure, rather than on teaching staff and supplies, undermines the quality and quantity of schooling. So may investing too much in higher education relative to basic literacy or elementary education. The skills being taught should match the needs and economic opportunities of the country.[26]

Facilitating the Transfer of Technology. Another channel through which aid might foster growth is technical assistance and technology transfer. That type of aid promotes growth not by accumulating greater resources but by making existing resources more efficient and effective. Technical assistance programs may also include educating and training government officials who play a large role in creating the policy environment and using foreign aid. Helping developing countries to organize institutions that protect property and minority rights is another example. As in other cases, the success of such programs will probably depend on the political and economic environment in which they operate. For example, according to some analysts, "assistance to encourage agricultural production had a substantially higher payoff in the presence of realistic exchange rate and trade policies."[27]

24. World Bank, *World Development Report 1995: Workers in an Integrating World* (New York: Oxford University Press, 1995), pp. 20-21.

25. Ibid., p. 37.

26. Ibid.

27. Krueger, Michalopoulos, and Ruttan, *Aid and Development*, p. 63.

Bilateral Versus Multilateral Assistance

As discussed in Chapter 2, aid is channeled to recipients through both bilateral and multilateral donors. Individual countries give aid through their own bilateral aid programs. Multilateral donors are the international financial institutions, such as the World Bank Group or the regional multilateral development banks, that receive their money from individual countries and capital markets and then lend it to developing countries. Both types of assistance programs have advantages and disadvantages in providing aid to developing countries.

Strengths and Weaknesses of Bilateral Aid Programs

From a developmental perspective, the strengths of bilateral aid programs include an ability to render effective technical assistance, build institutions, and develop close relationships with recipients. Donor policies that may hinder the usefulness of aid include giving aid for political reasons, tying aid to the purchase of the donor's goods and services, and adopting other economic policies—such as import quotas—that undermine the objectives of an aid program. Those policies may have important objectives in their own right, but they may come at a cost to development.

Close Relationships. Some nations tend to concentrate their aid on a few recipients. Consequently, bilateral donors may develop close, long-standing relationships with those recipients and thereby improve the effectiveness of aid. Cultural or linguistic similarities help create the skills needed for effective communication across national political boundaries. For example, the aid programs of France are directed toward many of its former colonies with whom it maintains a close relationship. Such relationships make it easier for the donor to render technical assistance and better understand what kind of aid programs might achieve the best results for the recipient.[28]

28. Cassen and others, *Does Aid Work?* p. 209.

Institution Building. Bilateral donors appear to have more practical experience in helping developing countries build various institutions that foster development, such as a judicial system, than do multilateral organizations. Thus, they are likely to be better placed to help aid recipients build such institutions on their own, particularly if the donor and recipient share a common language and, to some degree, a political heritage.

Functional Specialties. Bilateral donors have developed particular areas of expertise, such as strengthening public institutions (see Table 10). Having that expertise, however, does not necessarily mean that they will be successful or effective in applying it. In addition, major bilateral donors usually have a significant in-country presence that enables them to monitor their assistance and ensure that the amount of aid that is wasted or diverted is minimal.

Multiple Purposes of Foreign Aid. The reasons for which bilateral aid is given may affect its usefulness in promoting development. For example, the aid may be politically motivated; that is, developing countries are the recipients of donors' largesse because they are politically or strategically important, not because they are the ones most in need or most capable of making effective use of the aid. Aid may also be given to alleviate the effects of natural disasters or increase the donor's exports as well as to promote the economic and social development of the recipient. Whatever the motivation of the donor, foreign assistance will probably influence the development process of the recipient.

Nevertheless, foreign aid may not be as useful in encouraging economic growth when the donor shapes its program with another goal in mind. The recipient may know that it is considered strategically important and may therefore be unwilling to adopt policies that would promote long-term development, particularly if the policies are painful in the short run. Rather than adopt needed reforms, recipient countries may use the aid to compensate for inefficient economic policies.[29] Some prominent examples include U.S. assistance to Honduras and Egypt in the 1980s. From the recipient's point of view, however, the political winds in the donor

29. See, for example, the testimony of Nicolas Van de Walle, *The Future of Aid to Africa*, before the Subcommittee on African Affairs of the Senate Committee on Foreign Relations, May 1, 1996, pp. 4-5.

Table 10.
Functional Specialties of Major Bilateral Aid Donors

Country	Functional Specialty
United States	Covering a broad geographic area because of the size, breadth, and history of the U.S. aid program. Maintaining large in-country missions aiding country-specific analysis and long-term relationships with governments. Using U.S. institutions for public education and for mobilizing resources. Conducting research and training in agriculture.
Japan	Strengthening and investing in electrification and public utilities. Focuses aid on Asian countries.
France	Strengthening public and private institutions. Promoting the development of export crops. Focuses aid on former colonies.
United Kingdom	Strengthening public and private institutions. Promoting the development of export crops. Focuses aid on former colonies.
Germany	Strengthening and investing in public utilities.
Scandinavia[a]	Promoting alleviation of poverty, especially in countries that other donors would not or could not work in for political reasons.

SOURCE: Congressional Budget Office based on John W. Mellor and William A. Masters, "The Changing Roles of Multilateral and Bilateral Foreign Assistance," in Uma Lele and Ijaz Nabi, eds., *Transitions in Development: The Role of Aid and Commercial Flows* (San Francisco: ICS Press, 1991), pp. 352-353.

a. Sweden, Norway, Denmark, Finland.

country may change suddenly, resulting in a dramatic cutoff of aid, which could hurt development.

According to the Organization for Economic Cooperation and Development, however, the end of the Cold War has reduced much of that behavior. Donor states are becoming more selective and careful with respect to giving aid. Countries that seem unwilling to make reforms or take steps to help themselves are finding it increasingly difficult to attract economic assistance.[30]

Contradictory Policies. The economic or trade policies of a single donor may contradict and undermine its foreign assistance program. For example, a donor may give aid to a developing country to improve its industry and promote exports; at the same time, the donor raises trade barriers to the importation of the recipient country's products that the assistance was intended to promote. As one observer wrote:

> In Bangladesh, for example, U.S. authorities actively urged the government to promote manufactured exports of labor-intensive goods. Policies changed as a result, and some clothing exports soared in response. Soon after the boom, U.S. trade officials confronted Bangladeshi authorities eager to negotiate quotas that would restrict apparel exports to the United States! Such restrictions have been in place since 1986.[31]

Tied Aid. A donor may require a recipient to spend some or all of its foreign aid on goods and services pro-

30. Organization for Economic Cooperation and Development, Development Assistance Committee, *Development Cooperation 1994: Efforts and Policies of the Members of the Development Assistance Committee* (Paris: OECD, 1995), p. 89.

31. Anne O. Krueger, *Economic Policies at Cross-Purposes: The United States and Developing Countries* (Washington, D.C.: Brookings Institution, 1993), p. 63.

duced in the donor's country, a practice known as tying aid. In a newer form of tied aid, the donor offers aid as subsidized credit for the purchase of its exports. Donor governments then justify aid budgets by arguing that they promote their commercial objectives and exports.

The degree to which OECD countries tie their aid varies considerably and changes from year to year. In 1992, Spain tied nearly 86 percent of its official development assistance, compared with Norway at only 20 percent. The United States tied approximately 50 percent—nearly $6 billion—of its official development assistance. In 1993, however, those figures fell to 33 percent for Spain, 29 percent for the United States, and 11 percent for Norway.

The tying of funds may have hidden costs for the recipient. The *Development Cooperation 1994* report, put out by the OECD's Development Assistance Committee, cites the following:

- The aid may be given with the best interests of the donor in mind, not those of the recipient country.
- The subsidy involved in concessional aid may benefit the exporter rather than the recipient.
- Linkages between the development projects and the local economies are not formed. Thus, the local economy derives little long-term benefit from the projects.

No consensus exists, however, as to whether tying aid undermines its effectiveness. On the one hand, recipient countries sometimes manage to evade the tying effect of aid when it is imposed. On the other hand, studies of individual countries have found that tying aid increases the costs of goods purchased with foreign assistance by as little as 12 percent or by as much as 80 percent.[32] The *Development Cooperation 1994* report argues, however, that the tying of aid matters less than the degree of competition in the procurement process for aid contracts. Competition in awarding aid contracts, even if they must be awarded to the companies of the donor country, may provide better value than untied aid contracts that are not subject to a bidding process.[33] Most U.S. aid contracts are subject to competition, and only U.S. companies may compete for them. That would suggest that the prices for goods and services needed by U.S. aid-administering organizations are competitive, at least in the U.S. market.

32. Krueger, Michalopoulos, and Ruttan, *Aid and Development*, p. 81.

Strengths and Weaknesses of Multilateral Donors

Multilateral donors such as the World Bank or the regional multilateral development banks do not have some of the disadvantages of bilateral donors. Their aid is less politically motivated; they tend to give aid to the poorest countries. Nor do multilateral donors tie their aid. As some analysts have put it, multilaterals "can establish systems of international competitive bidding to purchase goods and services at the lowest possible cost and maximize the real value of aid flows."[34] Another advantage is that they will not undermine the objective of an aid program through other economic policies such as import quotas. They also have been able—more so than bilateral donors—to make longer-term and more stable commitments for aid geared to the resource needs of the recipient.

The central functional specialty of the multilateral organizations is promoting and supporting the economic reforms necessary for creating a policy environment that is conducive to economic growth. Those activities include opening trade regimes, minimizing restrictions on the private sector, and building economic infrastructure.[35]

The disadvantages of multilateral aid center around the relationship those donors have with recipients. The multilateral institutions provide most of their assistance

33. Organization for Economic Cooperation and Development, *Development Cooperation 1994*, pp. 28-29.

34. John W. Mellor and William A. Masters, "The Changing Roles of Multilateral and Bilateral Foreign Assistance," in Uma Lele and Ijaz Nabi, eds., *Transitions in Development: The Role of Aid and Commercial Flows* (San Francisco: ICS Press, 1991), p. 361.

35. Ibid., p. 360.

to the governments of recipient countries.[36] That practice may tend to increase the relative power of government in the economy and in promoting development in recipient countries. Bilateral donors, such as the Agency for International Development, may be more adept at helping to build the civil societies—labor unions, citizens groups, and watchdog organizations—in developing countries that serve as a check on the growth of government power and influence. Furthermore, the multilateral institutions may not have the expertise or experience in building institutions, such as an independent judiciary, that are so important in protecting property rights, enforcing contracts, and maintaining the rule of law.

Coordination Between Bilateral and Multilateral Donors

Development assistance received from multiple sources may create problems of administration and coordination in a recipient country and thereby undermine the effectiveness of aid. When donors approach a government with a proposed development project, the recipient country may agree to the project without integrating it into a comprehensive development framework. The lowest-income countries may not even have such a framework or may be so desperate for foreign assistance that they seldom refuse aid or challenge a donor's approach. That makes it possible for different donors to start contradictory programs or for multiple donors to duplicate projects, reducing the overall effectiveness of the assistance.

At the very least, an uncoordinated investment program from many donors may strain the capacity of a recipient to implement, monitor, and maintain those projects. For example, in the early 1980s, Kenya had approximately 600 active projects financed by 60 donors. Other African countries had similar experiences.[37] In contrast, other evidence suggests that the more the government of a recipient country is involved in leading and coordinating aid programs, the more effective and integrated those programs will be in promoting long-term development.[38]

The problem of coordinating donors has increased with the proliferation of bilateral and, especially, multilateral donors. In 1960, seven different multilateral aid agencies gave assistance to developing countries; by 1975, there were 15.

Formally, donors try to reduce these problems through two primary mechanisms: the World Bank consultative groups and the U.N. roundtables. Both donors and recipients attend those meetings to discuss the programs that will be undertaken in the coming years and to pledge support. If bilateral and multilateral donors wish to make greater use of their respective advantages and specialties, then close coordination may be necessary. For example, if a group of donors intend to encourage policy reform in a developing country, all donors must agree on the terms and conditions of granting the assistance, "otherwise, the more lenient lenders will undercut the rest, and the quality of development will suffer."[39]

However, some development experts believe that the presence of multiple aid donors in one country is not necessarily a bad thing.[40] Competition among donors may solve developmental problems and get results sooner. For example, if a donor has a good idea for a project to solve a particular problem, waiting for the next coordination meeting could create unnecessary and counterproductive delays.

The Nature of Aid Flows

The quantity and type of the development assistance affect the usefulness of aid in promoting economic and social development. Quantity appears less important than quality, and quality is determined in part by the type of assistance that countries receive. Program assistance and technical assistance are generally consid-

36. Indeed, the multilateral institutions are required to get the approval of the recipient government and its guarantee for loans. The only exceptions are the private windows of the banks. For example, the World Bank created the International Finance Corporation in 1956 precisely so that the private sector in developing countries could benefit from its largesse. Most of the other banks have similar operations. However, they represent a very small percentage of the overall operations of each multilateral development bank.

37. Krueger, Michalopoulos, and Ruttan, *Aid and Development*, p. 104.

38. Van de Walle, *The Future of Aid to Africa*, p. 5.

39. Cassen and others, *Does Aid Work?* p. 217.

40. Ibid.

ered to be the best types of aid to promote policy reform in recipient countries.

Quantity. The amount of foreign aid given to developing countries worldwide is small compared with the size of their economies—2 percent to 3 percent of their gross national product. In a few countries, that figure can exceed 60 percent in a given year, but in many developing countries, the figure is less than 10 percent (see Appendix B).

Nevertheless, more assistance is not always more effective. Too much foreign aid given to one recipient may overwhelm its ability to use the aid effectively and productively. Yet even a small quantity of aid can be useful in achieving results, depending on its purpose and how it is spent. If a small amount of aid can help convince a developing country to adopt market-oriented economic policies, it will probably do more good than a vast investment program in a hostile economic environment. That helps explain why there is no agreement on what amount of aid, if any, is needed to promote development.

Type. Development assistance is generally classified into three categories: project assistance, program assistance, and technical assistance. Project assistance refers to a specific investment in the recipient country, such as the building of a road or a dam. Program assistance is usually a cash transfer as general support for a country's overall development objectives. Technical assistance represents the transfer of knowledge from the donor to the recipient, either by bringing members of the recipient country to the donor to study or by sending experts from the donor country to the recipient to guide, teach, and ultimately transfer skills and technology.

No consensus emerges from the development literature as to which type of assistance is most effective. All three types have had successes and failures. Generally, if a developing country maintains political and economic policies that are favorable to long-term development, then each type of assistance is likely to be more productive over the long term. In the absence of such policies or a willingness to create them, all three types will probably be unproductive. Determining which type of assistance is the most useful for helping countries reform their economic policies is difficult.

If aid donors choose to help a developing country carry out policy reforms, then some degree of technical assistance is likely to be important in that effort. Many developing countries do not have the same depth of expertise and experience as developed countries, particularly in managing an economy. Thus, technical assistance will be highly useful either in training economists or in using economists as advisers to policymakers in developing countries.

For encouraging the actual reform effort, program assistance is generally a more useful and more flexible instrument than project assistance. Once begun, project assistance can be ended only at the risk of undermining the entire project; thus, its use as a tool of leverage is comparatively weak. But program assistance, because it is largely a cash transfer, can be turned on and off at will and disbursed quickly or slowly or in tranches as the recipient proceeds along a program of reform, thereby encouraging the right reforms or discouraging backpedaling or failure to reform. Thus far, donors, including the multilateral institutions, allocate most of their resources to project assistance. However, program assistance is growing in importance as donors increasingly recognize that the overall economic policy framework plays an extremely important role in determining whether a recipient will continue developing over the long term.

Chapter Four

The Challenge of Development: Illustrations from Eight Countries

To illustrate the themes presented in Chapter 3, the Congressional Budget Office reviewed the development experience of four pairs of countries: South Korea and the Philippines, Costa Rica and Honduras, Botswana and Zambia, and Tunisia and Egypt. The first country in each pair has achieved a greater degree of economic and social development than the second. In each comparison, except Botswana and Zambia, who achieved independence in the 1960s, CBO examined the 40 years from 1953 to 1993. CBO also looked at five important indicators of development in each of the eight countries (see Table 11). For most of those countries, foreign aid has represented a relatively higher portion of gross national product than have external flows of private capital (see Table 12).

This chapter discusses examples from one or more of the countries that seem to illustrate a theme or that run particularly counter to it. Thus, readers will not find a discussion of every point with respect to all eight countries.

The Influence of Governance on Development

The three elements of governance that seem to matter most in the development process are political stability, honest and competent government officials, and institutions. As the country examples reveal, however, the connection between governance and development is a matter of degree. None of CBO's successful development cases were completely stable or totally free of corruption. Nevertheless, more stable, less corrupt, and more capable countries seemed to achieve greater development than their less stable counterparts.

Political Stability

No country among the eight suffered from the kind of political instability and turmoil that one associates with Rwanda or Somalia in the 1990s. Excluding countries that had experienced such chaos was a deliberate analytic choice. It seemed self-evident that a country engulfed in a devastating, long-term civil war would be unlikely to develop. Nevertheless, the degree of political stability in the eight countries mattered with respect to development. But because some of the countries with weaker growth are also relatively stable, political stability appears to be a necessary but not sufficient condition for successful long-term development. Thus, with respect to this particular theme, each country is discussed both to emphasize the point that political stability alone will not lead to development and to provide brief political histories as background to the other points that will be illustrated in succeeding pages.

South Korea. Between 1953 and 1988, South Korea's government was stable and authoritarian. Syngman Rhee governed Korea as president until 1960 when he was driven from power by large-scale student demonstrations. Power was shifted to Prime Minister Chang Myon in a brief era of democratic, parliamentary government. However, nine months later, in the spring of 1961, a coup put the military in power, ending residual political instability from the upheaval of 1960. General Park, the leader of the 1961 coup, assumed the presi-

Table 11.
Indicators of Development for Eight Countries

Country	GNP per Capita[a] 1960	GNP per Capita[a] 1991	Population (Thousands) 1960	Population (Thousands) 1994	Literacy[b] (Percent) 1970-1975	Literacy[b] (Percent) 1985-1990	Infant Mortality[c] (Percent) 1967	Infant Mortality[c] (Percent) 1992	Calories Consumed Daily per Capita 1961	Calories Consumed Daily per Capita 1992
South Korea	800	9,790	25,003	44,563	88	96	58	11	2,187	3,285
Philippines	911	2,893	27,560	66,188	83	90	72	44	1,708	2,255
Costa Rica	1,963	5,002	1,236	3,304	88	93	68	14	2,168	2,886
Honduras	733	1,583	1,894	5,493	57	73	119	43	1,960	2,306
Botswana	964	3,123[d]	480	1,443	41	72	105	43	2,054	2,264
Zambia	879	685	3,141	9,196	n.a.	73	115	104	2,140	1,931
Tunisia	1,067[e]	3,571	4,221	8,815	38	65	138	43	2,069	3,332
Egypt	330[e]	2,781	27,840	57,556	n.a.	48	170	67	2,281	3,335

SOURCE: Congressional Budget Office based on data from the World Bank, the Agency for International Development, and the University of Pennsylvania.

NOTE: n.a. = not available.

a. Gross national product (GNP) is in 1994 dollars and is calculated using estimates of purchasing power parity.

b. Literacy is the percentage of literate people in the population over the age of 15. (The data represent a survey made at some point during the five-year period.)

c. Infant mortality represents deaths per 1,000 live births.

d. Value is for 1989.

e. Value is for 1961.

dency and launched Korea on its successful path of development. The Revolutionary Committee, headed by Park, later wrote a new constitution, held elections, and restored the appearance of a democracy. Park served as president until his assassination in 1979.

After another brief period of constitutional government, a faction of the military reasserted direct control, extending martial law and installing General Chung Doo Hwan as president in 1980. In 1987, however, South Korea moved to a more democratic system and held fair elections that were won by the ruling party. Despite the political upheaval in 1979 and 1980 and the changes in government, Korea's approach to development has been fairly consistent and stable for the past 35 years.

The Philippines. The Philippines was a democracy in the 1950s and 1960s, though in practice a landed oligarchy dominated the political system. Ferdinand Marcos, who was not a member of the oligarchy, was elected president in 1966. He was reelected in 1969, but in 1972, in the wake of domestic disorder, he staged a coup whereby he dissolved the legislature, shut down the media, and arrested hundreds of individuals in the name of restoring domestic political order. He ruled by decree and wrote a new constitution—actions that have been called "constitutional authoritarianism."[1] He ruled

1. Robert S. Dohner and Ponciano Intal, Jr., "The Marcos Legacy: Economic Policy and Foreign Debt in the Philippines," in Jeffrey D. Sachs and Susan M. Collins, *Developing Country Debt and Economic Performance*, vol. 3, *Country Studies—Indonesia, Korea, Philippines, Turkey* (Chicago: University of Chicago Press, 1989), p. 386.

until driven from power by a "people's power" revolution in 1986.

Around the time of Marcos's coup, a Muslim-led insurgency broke out in the southern part of the country. The Philippines is overwhelmingly Christian, and the Muslim forces sought greater autonomy. Although that conflict was a seemingly intractable problem that took more than 20 years to end, it was confined and did not impinge much on the normal business of most of the country. Marcos also had to deal with the Marxist-oriented New People's Army in the northern part of the country. Few experts on the Philippines attribute a major portion of its underdevelopment to those problems, however. Other factors, such as corruption, seemed to matter more.

Costa Rica. Political stability in Costa Rica was provided through a democratic system of government and was an important element of its long-term development

Table 12.
Flows of Foreign Aid and International Private Capital to Eight Countries as a Share of Gross National Product (In percent)

Country	1970-1974	1975-1979	1980-1984	1985-1989	1990-1993
South Korea[a]					
Aid flows	8.6	3.8	1.8	0.6	0.2
Private flows	2.9	3.7	-3.2	-1.1	2.1
Philippines					
Aid flows	4.2	3.9	3.5	5.1	6.9
Private flows	0.6	3.8	2.3	0.9	1.9
Costa Rica					
Aid flows	3.4	3.8	6.7	9.3	7.0
Private flows	5.0	5.7	3.9	2.6	2.4
Honduras					
Aid flows	3.0	4.5	8.7	8.8	7.4
Private flows	1.3	2.1	1.5	1.4	1.0
Botswana					
Aid flows	36.6	18.2	13.0	11.8	4.3
Private flows	0.3	7.5	6.9	3.9	-1.4
Zambia					
Aid flows	5.1	7.8	10.4	20.2	31.1
Private flows	0.4	2.9	2.1	7.9	1.4
Tunisia					
Aid flows	7.7	7.3	7.6	7.9	7.2
Private flows	1.2	5.6	3.9	1.4	1.5
Egypt					
Aid flows	5.6	21.1	12.0	10.9	16.0
Private flows	0.1	4.3	5.7	5.2	-1.2

SOURCE: Congressional Budget Office based on data from the Agency for International Development, the Organization for Economic Cooperation and Development, and the World Bank.

NOTE: Data reflect averages for the period shown.

a. South Korea received a substantial amount of foreign aid in the 1950s and 1960s—amounts far in excess of anything received since 1970. However, data for private capital flows before 1970 were unavailable.

success. Costa Rica is the oldest continuously functioning democracy in Latin America. It is governed by a parliament and an executive, and in most elections since 1950, the presidency has alternated between the two major political parties: a social democratic party known as the Partido Liberación Nacional (PLN), and a loose coalition of forces opposed to the PLN.

That political stability played an important role in promoting Costa Rica's economic growth because it favored investment and the strengthening of institutions. In 1948, after a two-month civil war, the army was disbanded and was never reestablished. Costa Rica avoided the political upheaval that much of Central and South America has experienced over the past 40 years, and that stability fostered sustained foreign investment. Costa Rica's political culture was and is oriented toward political stability, peaceful resolution of conflicts, and a willingness to evolve without abrupt changes. Unlike many of its neighbors, it was spared from a guerrilla war during the 1970s and 1980s.

Honduras. In contrast, Honduras has not had such political stability. Honduran politics have been highly contentious, and the military has not hesitated to intervene directly in the political process. Unlike Costa Rica, which dissolved its army in 1948, the Honduran military transformed itself in the 1950s into a modern professional organization. Of the 12 changes in the executive between 1953 and 1993, five were coups. The military became an independent, and one of the most powerful, interest groups within Honduran government and politics.[2]

Although some reformist military governments have taken positive steps to promote Honduras's development, overall the pervasive influence of the military appears to have contributed to the country's underdevelopment. During the 1980s, the military claimed 20 percent to 30 percent of the government budget. Another problem was that the coups disrupted the political stability of the country and sometimes brought to an end reformist liberal governments. Finally, according to Kent Norsworthy and Tom Barry, Honduras suffers from a deep fear of its neighbors.[3] The powerful influence of the military in Honduran society appears to have done little to alleviate that fear.

Botswana. Political stability was not an issue in the two countries of sub-Saharan Africa that CBO examined. Botswana combines some attributes of both South Korea and Costa Rica. Since its independence in 1966, Botswana has been a stable democracy. Yet the same party—the Botswana Democratic Party—has been in power since independence, guiding Botswana's development. The opposition party, the Botswana National Front, has gained almost one-third of the seats in parliament and won most of the local elections in larger cities and towns.

Zambia. Zambia, too, has enjoyed a fair degree of political stability since independence in 1964. Until 1991, Zambia was governed by a one-party political system. President Kenneth Kaunda, leader of the United National Independence Party, ruled Zambia free of major political unrest or civil war. In 1991, partly as a result of popular disenchantment with the state of the economy, President Kaunda promised to hold free and fair elections. As a result, an opposition group came to power peacefully.

Tunisia. Tunisia is one of the more stable and developed countries of North Africa and the Middle East. Governed by the Destourian Socialist Party since independence in 1957, Tunisia's administration has been flexible and pragmatic in implementing development policy. In the 1970s, for example, international confidence in Tunisia's political stability helped strengthen its economy. In 1975, Habib Bourguiba, president since 1957, became "president for life." He was ousted in 1987 by Zine el-Abidine Ben Ali, who is pushing Tunisia toward a market economy if not a democratic course. The Destourian Socialist Party was renamed the Constitutional Democratic Party in 1988 but remains the ruling party.

Egypt. Egypt has also had relative political stability, though somewhat less so than Tunisia. Only three presidential administrations have governed Egypt since 1952—those of Gamel Abdul Nasser, Anwar Sadat, and Hosni Mubarak. Nasser came to power in a coup that overthrew the monarchy. Sadat was Nasser's vice president and succeeded him in 1970 on Nasser's death. Mubarak was Sadat's vice president and became president on Sadat's assassination in 1981.

2. James A. Morris, *Honduras: Caudillo Politics and Military Rulers* (Boulder, Colo.: Westview Press, 1984), pp. 35-37.

3. Kent Norsworthy with Tom Barry, *Inside Honduras* (Albuquerque: Inter-Hemispheric Education Resource Center, 1993), p. xvii.

Despite its surface of relative calm, Egypt's stability is often described as delicate. The government has had to quell occasional riots, such as the food riots of the 1970s, when Sadat attempted to reduce food subsidies. Since 1952, Egypt had been involved in three wars with Israel before signing the Camp David Accords in 1979. In addition, Egypt openly sided with the republican forces in the Yemen War in the mid-1960s, consuming valuable resources for several years. Finally, extremist religious factions—the same ones that assassinated President Sadat—seek to remove the government and transform Egypt into an Islamic republic.

This very brief survey of the political histories of the eight countries substantiates the assertion that political stability may be a necessary but not sufficient condition for successful long-term development. None of the eight countries experienced severe political turmoil or civil war during the period that CBO examined, yet some countries have been more successful in their development than others. Political stability in Zambia, for example, has not been enough to produce long-term development. And Costa Rica has probably been the most stable of the countries; its economy has grown rapidly over the past 30 years, but not as fast as South Korea's. Costa Rica has also been more stable than Honduras, which has had more difficulty in achieving long-term development. Clearly, political stability matters up to a point, but it is not enough.

Honest and Competent Government Officials

Because the particular countries CBO chose were relatively stable politically (at least compared with countries like Somalia or Bosnia), corruption and the influence of self-serving government officials probably had a greater impact in shaping the development histories of the eight countries. The differences between the more successful and less successful countries on this variable were probably the most pronounced in the Asian and African nations, but they mattered in Latin America and the Middle East as well.

South Korea. Corruption under Rhee and Park was significant, though hard data on its extent do not exist. Still, corruption in the 1950s was more detrimental than that in later years because of the economic policies pursued by the Rhee government.

Corruption under Rhee was in the form of payoffs from foreign aid funds and bank loans. "Inflation, an overvalued exchange rate, low interest rates, and elaborate government controls formed an environment in which such corruption operated profitably for those involved but to the detriment of sound investments or national economic development."[4]

In contrast, corruption under Park took the form of payoffs from private investment. But the payoffs took place in an economic environment more favorable to growth. Thus, the private capital, "despite pay-offs and the like—fed an investment boom that followed reasonably accurate market indicators of real benefits and costs for the country."[5] Investments approved by the government, even though payoffs were extracted from them, had been tested and approved through feasibility studies and were generally consistent with Korea's economic plan.[6]

The Philippines. Of all the countries CBO examined, corruption appears to have posed the greatest problem in the Philippines. In the 1950s and 1960s, the Filipino political system was used as a means to enrich members of the ruling elite. As one member of the Philippine senate put it: "What are we in power for? We are not hypocrites. Why should we pretend to be saints when in reality we are not?"[7]

Under Marcos, however, the use of the political and economic system to benefit the president and his friends expanded on a massive scale. Robert Dohner and Ponciano Intal have characterized their behavior as "crony capitalism" and attribute to it a major portion of the blame for the Philippines' underdevelopment. Crony capitalism was conducted through various means, such as awarding government contracts to the politically favored, padding expenses, and providing kickbacks. But "the most important aspect was the creation of monopolies, either through direct intervention to control an industry or through granting exemptions

4. David C. Cole and Princeton N. Lyman, *Korean Development: The Interplay of Politics and Economics* (Cambridge: Harvard University Press, 1971), p. 252.

5. Ibid.

6. Ibid.

7. Quoted in James K. Boyce, *The Philippines: The Political Economy of Growth and Impoverishment in the Marcos Era* (Honolulu: University of Hawaii Press, 1993), p. 8.

or exclusive privileges to favored individuals."[8] For example, in the forestry sector, some of the logging licenses went to government ministers and Marcos's friends. Even when some land was allocated to others, Marcos's allies were allowed to log in those areas under the pretext of clearing the forest for settlement projects of the Ministry of Agrarian Reform.[9] Overall, the cost to the Philippine economy of crony capitalism is hard to measure, but the cost of the monopolies alone was in the billions of Philippine pesos, not counting all the investment they may have discouraged and capital flight they encouraged.[10]

Moreover, Yoshihara Kunio, in a comparative study of the Philippines and Thailand, has argued that corruption has extended to the Philippine police forces and judiciary. Many police have worked for criminal syndicates. High-ranking police officials receive a modest salary yet live luxuriously. The Philippine police, Yoshihara concluded, are "probably the most corrupt government agency in the Philippines."[11] Some judges were allegedly influenced by money during trials; even before martial law, the rich and powerful in the Philippines could evade punishment for many crimes, including murder.[12]

As martial law corrupted law enforcement and the economy deteriorated, the crime rate exploded. That contributed to the flight of domestic capital from the Philippines during the 1970s and 1980s. Private property of the poorer classes was often confiscated by wealthy individuals, and the poor could do little about it except join the rebels. Owners of small firms would lose their businesses to criminals who used fake titles or legal gimmicks to claim property they did not own, and the judges would uphold their tactics.

Botswana and Zambia. Botswana has suffered from far less corruption than Zambia. The first president of Botswana, Sir Seretse Khama, established the tradition of an accountable and transparent government. He helped set a precedent for an effective government with a culture of openness, accountability, and little corruption that has been maintained over time. Corruption in Zambia has been far greater. Government leaders have spent millions of dollars on personal perquisites. Zambia's government has also wasted resources by employing large numbers of people for political reasons rather than for providing services.

Governmental Institutions

Certain governmental institutions seem important to the development process. For example, having the means to secure and protect property rights generally means having an independent and fair judiciary to enforce the relevant laws. Similarly, governments appear to need the ability to regulate the monetary system, such as exchange rate policy, and thus may require a finance ministry or a central bank. To provide some essential services, governments must have the means to collect taxes.

In practice, these issues are more ambiguous in the countries CBO examined. For example, the judicial system in Costa Rica is well established and provides a framework for defining and enforcing contracts.[13] Property rights are well defined and protected under the judicial system. In theory, that should make it easier for foreign and domestic entrepreneurs to invest and start businesses, profit from them, and create jobs and spur economic growth in the process. Political stability in general has reduced the risks and transaction costs of operating in the Costa Rican society and economy.[14]

Similarly, Honduras has also taken important steps to build institutions. The Galvez administration in the 1950s began to modernize the Honduran government and, in particular, to establish institutions that would further national development. Notably, Galvez created the Central Bank of Honduras to control monetary policy and established an agricultural development bank. He also created the Ministry of Economy, the National Council on Economics, the Board of Budget Management, and the Income Tax Board—all of which were

8. Dohner and Intal, "The Marcos Legacy," p. 399.

9. Boyce, *The Philippines*, pp. 233-234.

10. Dohner and Intal, "The Marcos Legacy," pp. 478-479.

11. Yoshihara Kunio, *The Nation and Economic Growth: The Philippines and Thailand* (New York: Oxford University Press, 1992), p. 193.

12. Ibid., p. 194.

13. Simon Rottenberg, ed., *Costa Rica and Uruguay: The Political Economy of Poverty, Equity, and Growth* (Washington, D.C.: World Bank, 1993), pp. 20-21.

14. Ibid., p. 127.

intended to create the means for modern development.[15] But the existence of those institutions has not been sufficient to generate economic growth.

The Influence of Domestic Economic Policies on Development

The literature on development discussed in Chapter 3 stresses that the economic policies a country pursues will have an important influence on its development. That observation was borne out in most of the countries that CBO studied, but perhaps the best comparison is South Korea and the Philippines.

South Korea

South Korea has used both import-substitution and export-led industrialization strategies at various times. In the 1950s under Syngman Rhee, Korea adopted an inward-looking, import-substitution strategy of industrialization. High tariffs and quotas protected domestic industry. The exchange rate was both controlled and overvalued. In 1954, exports accounted for less than 1 percent of GNP; by 1962, that share had risen to only 2 percent. The economy was highly dependent on foreign aid. Although the economy grew initially as a result of reconstruction efforts that followed the Korean War, high inflation was the price.

A military coup in 1961 brought Park Chung Hee and an authoritarian, technocratic government to power. During the 1960s, he set about reforming the economy. The government reformed the exchange rate system and devalued the currency, promising exporters that it would protect their rate of return no matter what the rate of inflation was. It also liberalized trade and lowered tariffs. Interest rates on bank deposits and loans were doubled to increase private saving and discourage unproductive use of credit. However, government involvement in the economy under Park was still considerable. For example, the government made institutional reforms in the financial system and allocated investment credit.

The results transformed South Korea's economy between 1962 and 1982. The primary sector of the economy—agriculture and natural resources—fell from about 45 percent of GNP in 1962 to about 19 percent in 1982 (see Table 13). Manufacturing, in contrast, grew from 9 percent to 34 percent over those 20 years. Economic growth paralleled the rise of manufacturing in the economy. Between 1963 and 1976, GNP grew at the astounding rate of 9.2 percent a year. Per capita GNP growth was equally impressive at 7.2 percent a year. Those developments were largely financed by the dramatic rise in domestic saving that government policies had promoted.

Exports grew in quantity and breadth. Accounting for only 2 percent of GNP in 1962, exports represented over 16 percent by 1972 and nearly 32 percent by 1982. The change in the number of countries to which

Table 13.
Transformation of South Korea's Economy Between 1954 and 1982 as a Share of Gross National Product (In percent)

Sector	1954	1962	1972	1982
Primary Sector[a]	51.1	45.3	29.2	19.2
Manufacturing	5.3	9.1	20.9	34.2
Social Overhead and Services	43.6	45.6	49.9	46.6
Exports	0.8	2.0	16.4	31.8
Imports	7.2	15.6	23.7	36.5
Domestic Investment	11.9	12.8	21.7	26.2
Domestic Saving	6.6	3.3	15.7	21.5
Foreign Saving	5.3	10.7	5.2	4.8

SOURCE: Congressional Budget Office based on data from Kim Kwang-suk and Park Joon-kyung, *Sources of Economic Growth in Korea, 1963-1982* (Seoul: Korea Development Institute, 1985), p. 9.

a. Includes agriculture and natural resources.

15. Mark B. Rosenberg and Philip L. Shepherd, eds., *Honduras Confronts Its Future* (Boulder, Colo.: Lynne Rienner, 1986), p. 99.

Table 14.
Standard-of-Living Indicators for the Philippines

Indicator	1962	1966	1970	1974	1978	1982	1986
Wage Rate[a]							
Agricultural	100	93.6	75.9	54.2	87.6	65.0	70.7
Skilled worker	100	89.1	89.5	55.3	54.0	48.8[b]	27.8
Unskilled worker	100	96.1	103.3	63.0	57.2	41.1[b]	25.7
Total Unemployment (Percent)	21.8[c]	22.0	14.9[d]	10.6	14.7	24.1	22.9
Prices[e]							
Food	20.4	27.6	33.4	74.5	100	162.5	329.1
Nonfood	27.8	29.6	36.1	70.1	100	186.3	387.3

SOURCE: Congressional Budget Office based on data from James K. Boyce, *The Philippines: The Political Economy of Growth and Impoverishment in the Marcos Era* (Honolulu: University of Hawaii Press, 1993).

a. Daily wage rate index: 1962 = 100.

b. Value shown is for 1983; value for 1982 is not available.

c. Value shown is for 1961; value for 1962 is not available.

d. Value shown is for 1971; value for 1970 is not available.

e. Food price index: 1978 = 100.

Korea exported was particularly astonishing. In 1954, Korea exported to only five countries. By 1976, it was exporting to 175 countries. According to one study, expansion of exports accounted for 31.8 percent of Korea's growth in industrial output between 1963 and 1975.[16]

South Korea's economy has flourished despite the existence of a number of public enterprises. Unlike the enterprises in many developing countries, those in South Korea generally have been efficiently run and have contributed substantially to economic growth. One reason for that achievement may be the willingness of the government to take action to address problems. "In Korea, there have been numerous cases of divestiture, most notably in the 1967-1969 period. And if a Korean public enterprise considered important for development shows signs of becoming moribund, it is likely to be vigorously kicked back into life by drastic changes in management and operating procedures."[17] For example, the government asked a private firm to manage Korean Air Lines when it was not profitable as a public endeavor.

The Philippines

The Philippines, however, did not fare as well. After Marcos declared martial law in 1972, he attempted to stimulate growth through expansionary fiscal policies and continued import substitution. That program enjoyed only modest success. Between 1973 and 1979, GNP and per capita GNP grew at an average annual rate of 4.8 percent and 2.7 percent, respectively.

The average Filipino, however, did not participate in those economic gains. Real wage rates for agricultural workers declined by 25 percent between 1966 and 1986 (see Table 14). Urban workers, both skilled and

16. Edward S. Mason and others, *Economic and Social Modernization of Korea* (Cambridge: Harvard University Press, 1980), pp. 139, 152-153.

17. Ibid., p. 275.

unskilled, fared even worse: their real wages declined by 69 percent and 73 percent during the same period. Thus, although the economic pie was growing larger, the distribution of that pie was shifting against the poorest segments of the population. Between 1970 and 1985, the percentage of the population living in poverty increased dramatically:[18]

Year	Percentage of Population in Poverty
1965	41.0
1971	43.8
1975	51.5
1985	58.9

The consequences of Marcos's economic policies, however, caught up with the economy, which was unable to weather the oil shock of 1980. Between 1980 and 1986, GNP hardly grew at all, per capita GNP dropped an average of 2.8 percent a year, and export earnings declined. The government tried to alleviate those conditions by increasing government expenditures and foreign borrowing. The external debt nearly doubled in four years. But foreign and domestic investors were not confident that the economic problems were short term. Net foreign investment declined to almost nothing, and the amount of capital leaving the country may have reached 5 percent of GNP in 1981 and 1982. By the time Marcos was overthrown in 1986, the Philippine economy was in dire straits. Economic reforms introduced by his successors appear to be putting the Philippines back on a growth track, but the economy may take decades to recover fully.

Botswana

Botswana provides one of the best illustrations of sound fiscal policies. Its economy has benefited tremendously from the discovery of diamonds in the period immediately after independence. Diamonds represent approximately 80 percent of Botswana's exports. But unlike other developing countries that sometimes squander such windfalls on consumption, Botswana has used its resources wisely and managed its economy well. Since it achieved independence in 1966, the government's development strategy has included high levels of investment, a conservative fiscal policy, and an appropriately valued exchange rate. Because much of the national revenue comes from nonrenewable mineral resources, the government has avoided using earnings from those resources for recurrent expenses and has instead invested them in infrastructure.

One indicator of that strategy, other than GNP growth, is that in the early 1990s, Botswana's external debt represented less than 20 percent of GNP. In addition, as of 1993, Botswana had foreign exchange reserves equal to approximately 30 months' worth of imports. Botswana's per capita GNP grew at an average annual rate of 7 percent in real terms between 1965 and 1994.

Zambia

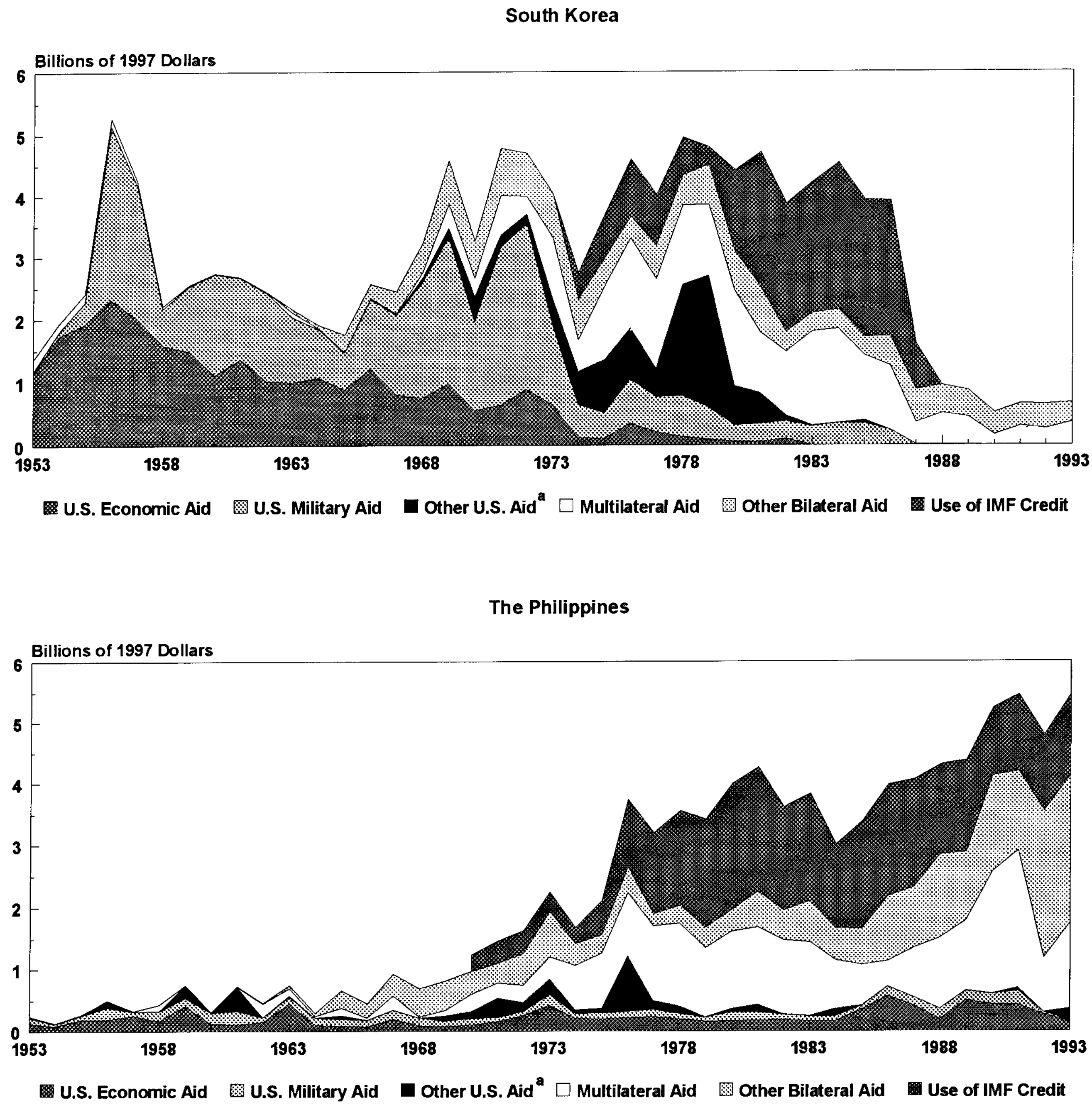
In contrast, Zambia pursued different economic policies, to its detriment. At independence, Zambia had extensive reserves of copper and was enjoying high copper prices. Shortly after independence, however, the government used the revenues from the country's primary export to expand the role of government. Between 1963-1964 and 1967, the number of civil servants more than doubled. The government nationalized many of the natural resources and industry, and social welfare spending rose dramatically. During the 1970s and 1980s, the government subsidized agriculture, instituted price controls, maintained a fixed exchange rate that became overvalued, and restricted trade. The new government-run industries became increasingly inefficient. High copper prices in the 1970s—and thus high export revenues—hid the first signs of those problems, but by the 1980s, copper prices had fallen, and the inefficiencies that had been built into the economy caused a period of long-term decline. Between 1965 and 1994, Zambia's per capita GNP dropped at an average annual rate of 0.9 percent.

The Role of Foreign Aid in Development

As was observed in Chapter 3, the more favorable the overall policy environment in a developing country, the

18. Boyce, *The Philippines*, p. 46.

Figure 5.
Foreign Aid to South Korea and the Philippines, 1953-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development, the Organization for Economic Cooperation and Development, and the World Bank.

NOTE: IMF = International Monetary Fund.

a. Mostly loans from the Export-Import Bank.

Table 15.
Domestic and Foreign Saving in South Korea, 1958-1974 (Saving as a percentage of total investment)

Year	Total Investment as a Percentage of GNP	Domestic Saving		Foreign Saving[a]	
		Private	Government	Transfers	Borrowing
1958	12.9	62.5	-24.1	69.8	-8.2
1959	10.7	61.5	-25.0	67.0	-3.5
1960	10.9	33.2	-18.7	82.3	-4.0
1961	13.1	42.8	-13.6	69.5	-4.3
1962	13.0	22.1	-10.7	72.9	10.0
1963	18.4	39.0	-1.4	37.8	20.6
1964	14.5	44.8	3.5	43.5	5.1
1965	14.7	38.1	11.5	44.2	-2.0
1966	21.6	41.6	13.0	26.5	12.5
1967	21.9	35.5	18.5	21.7	18.5
1968	26.7	27.5	23.5	14.6	28.5
1969	29.8	38.0	20.8	11.4	25.5
1970	27.2	34.5	25.5	8.0	27.4
1971	25.6	33.3	23.6	7.4	36.6
1972	20.9	53.1	18.6	8.3	18.4
1973	26.2	66.9	17.4	5.9	9.5
1974	31.4	51.7	9.6	4.3	38.9

SOURCE: Congressional Budget Office based on data from the Korean Economic Planning Board.

NOTES: Domestic saving and foreign saving should total 100 percent. However, the total may be off by a few percent because of various statistical discrepancies.

GNP = gross national product.

a. Foreign transfers and perhaps a small proportion of foreign borrowing represent foreign aid. Most foreign borrowing is private capital. Negative numbers mean that loan repayments exceeded additional borrowing.

more productive aid can be in promoting economic and social development. Aid may also be helpful in an unfavorable environment if the recipient is willing to make serious economic reforms. But aid given in an unfavorable policy environment to a recipient that is unwilling to make economic reforms may actually harm the recipient. The foreign aid experience in South Korea and the Philippines provides an excellent contrast of all three points.

South Korea

In the 1950s, South Korea under Syngman Rhee received massive amounts of foreign aid (see Figure 5). In 1997 dollars, Korea received a total of $23 billion in aid between 1953 and 1960. The average annual amount of economic aid over that same period was $1.8 billion. Rhee followed an inward-looking, import-substitution strategy of industrialization. The result was modest economic growth.

In the 1960s under President Park, Rhee's successor, South Korea received the same amount of aid overall—$23 billion in 1997 dollars—but less economic aid. The average annual amount of economic assistance fell to $1.3 billion. Nevertheless, the adoption of an outward-looking, export-oriented economic strategy produced vigorous growth in the succeeding decades.

The contrast between the two administrations is illustrated by their respective investment and saving rates. South Korea's investment rates—an important indicator of economic growth—grew from about 13 percent in 1958 to over 31 percent in 1974 (see Table 15). During the 1950s, the Rhee government made lit-

tle effort to increase domestic saving. Instead, it sought to maximize foreign assistance. Foreign transfers made up more than half of Korea's total investment between 1958 and 1962. In contrast, after Park instituted the First Five-Year Plan (and more economic reforms) in 1962, the long-term trend of total investment rose substantially, accompanied by an increase in domestic saving. The role that foreign transfers played in South Korea's growing economy correspondingly shrank, but they still bolstered the investment and saving rates.

The usefulness of technical assistance on economic issues given to South Korea under Presidents Rhee and Park also depended on having a government committed to creating a policy environment favorable to economic growth. Economic advisors to Rhee from the Agency for International Development often tried to make reforms that would lead to greater economic growth, but such advice usually went unheeded. Under President Park, however, AID personnel played a key role in advising South Korea on reforms it needed to make in the export sector to create an outward-oriented, exporting economy. The government was willing to make such reforms and, consequently, made good use of that advice.[19]

The Philippines

Foreign aid provided to the Philippines under Marcos may have actually hurt its development by reinforcing his economic mismanagement and corruption. Between 1966 and 1986, the international community gave or lent approximately $33 billion in 1997 dollars to the Philippines, most of which was economic assistance (see Figure 5). But per capita GNP averaged only 0.8 percent growth during those years. Moreover, poverty increased, and rural and urban wages declined dramatically. The Philippines' external debt as a percentage of GNP grew from 13 percent in the mid-1960s to 93 percent in 1986. And calculations of capital leaving the Philippines between 1962 and 1986 totaled over $19 billion, not including an adjustment for lost interest. Before being driven from power, Marcos, his family, and close associates "recycled" a substantial amount of the Philippines' external borrowing by sending or taking it out of the country.[20]

In contrast, foreign aid probably helped the Philippines reform its economy after Marcos, even though initially the economic policy environment remained unfavorable to growth. After Marcos was driven from power, the major foreign donors joined together in a cooperative aid program to the Aquino government—the Multilateral Assistance Initiative. The MAI was an effort designed by the United States to rally the international community to help rebuild the Philippine economy and support democracy. The reform program of Corazon Aquino and Fidel Ramos, Aquino's successor, has received strong support from the MAI donors. The United States, the International Monetary Fund, and the World Bank played critical roles in helping amplify, fine-tune, and promote the reform agenda.

The MAI also funded various regional development activities, placing particular emphasis on building infrastructure. Although determining the precise responsibility of foreign aid is difficult, those efforts helped build an economy that has flourished since the early 1990s. In 1995, Philippine Finance Secretary Roberto de Ocampo credited the MAI with helping bring that about: "A large part of the credit for our dramatic turnaround and persistent push towards a track of high growth can be owed to strong international support—specifically to the Multilateral Assistance Initiative."[21]

Aid and Human Capital

Foreign aid may also contribute to the growth of human capital. Although in CBO's cases the amount of aid allocated to that area is a fraction of that devoted to promoting economic growth, it has produced positive results, particularly in education and health. For example, U.S. foreign aid in Egypt contributed significantly to improving education among the country's poor, despite an economic policy environment that was less than favorable. The United States spent nearly $300 million in nominal dollars on Egypt's Basic Education

19. See Agency for International Development, Bureau for Global Programs, Field Support and Research, *USAID and Economic Policy Reform: Origins and Case Studies* (forthcoming).

20. Boyce, *The Philippines*, pp. 279, 295, 297. Some estimates put the amount in the billions of dollars.

21. Quoted in Agency for International Development, *The Philippines: Results Review and Resource Request* (March 1996), p. 5.

Project. That effort focused on increasing enrollment in primary school among Egyptian children, particularly girls. The project has constructed more than 1,800 schools that enroll 900,000 students each year; it has also provided instructional materials and equipment. According to one analysis, "Country-wide statistics indicate that from 1981 to 1990, total primary school enrollment increased by 41 percent, and female enrollment increased by 57 percent; nearly four-fifths of school-age girls now attend primary school. These dramatic increases were achieved, in significant part, due to AID's support of the primary education sector."[22]

Bilateral Versus Multilateral Assistance

As discussed in Chapter 3, the purposes, conditions, and means by which donors give aid to developing countries may affect how useful the aid is in promoting economic and social development. The country studies reveal problems associated with giving aid for multiple purposes, particularly in Egypt, Costa Rica, and Honduras. Egypt also illustrates how the donors' trade policies and tied aid may undermine developmental objectives. Those issues have been associated with bilateral donors. Botswana demonstrates the value of effective coordination of aid from both bilateral and multilateral donors.

The Multiple Purposes of Aid

The problems that aid given for more than one purpose causes for development are best illustrated by Egypt. The Agency for International Development first set up a mission there in 1975, the year after President Sadat began to turn Egypt's foreign policy toward a pro-Western orientation. The United States began providing substantial economic and military assistance to Egypt at that time, averaging $1.7 billion a year (in 1997 dollars) between 1974 and 1978.

Egypt's willingness to seek peace with Israel culminated in the 1979 Camp David Accords. In that year, Egypt received a large increase in military assistance (see Figure 6). Since the Camp David Accords, the amount of annual U.S. assistance has averaged $3.2 billion a year. In foreign operations legislation, the Congress has expressed its view that the recommended levels of assistance for Egypt and Israel are based largely on their continued participation in the Camp David Accords and on the Egyptian-Israeli peace treaty.

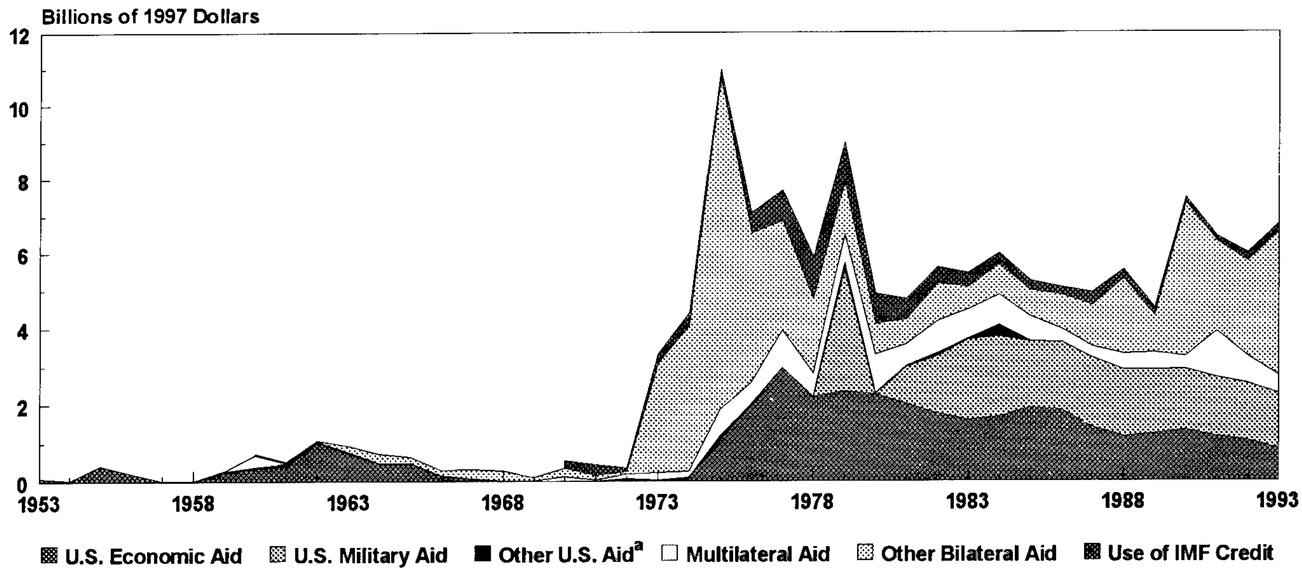
At the same time, the U.S. aid program to Egypt —unlike the aid program to Israel—became a major effort on the part of AID. The mission in Cairo soon became the largest in the world, employing over 100 people directly hired by the United States. Thus, the United States has been providing aid to Egypt in part for the political objective of keeping the peace in the Middle East but also with the hope of encouraging economic and social development.

From the political perspective, the aid seems to have worked. Egypt and Israel have not gone to war since 1973 and have maintained a peaceful dialogue since 1979. Barring a radical change in Egypt's leadership, few observers expect Egypt and Israel to return to the pre-Camp David relationship. Furthermore, Egypt may be considered one of the United States' regional allies. For example, Egypt sent 30,000 troops to Saudi Arabia to participate in Desert Shield and Desert Storm and provided political support to the allied coalition.

From a developmental perspective, however, the record is mixed. Although Egypt's GNP grew at an average annual rate of 5.6 percent between 1974 and 1993, the country has fared far less well with respect to economic development. The country's external debt, which is largely related to foreign aid, grew from about 30 percent of GNP in 1974, peaked at 170 percent in 1988, then fell back to a little more than 100 percent by 1994, largely because of debt forgiveness programs offered by various aid donors. As a proportion of gross domestic product, manufacturing has declined from 18 percent in 1974 to 15 percent in 1995, although that drop is partly attributable to the growth in oil revenues. Unemployment in Egypt's growing population has been rising. The economy has been dominated by large public enterprises that the government has used to try to employ more and more people. Those enterprises have

22. Roy L. Prosterman and Timothy Hanstead, *Egyptian Development and U.S. Aid: A 25-Year Perspective*, Rural Development Institution Monograph (March 1992), p. 22.

Figure 6.
Foreign Aid to Egypt, 1953-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development, the Organization for Economic Cooperation and Development, and the World Bank.

NOTES: Data do not reflect aid from former communist countries.

IMF = International Monetary Fund.

a. Mostly loans from the Export-Import Bank.

become less and less efficient, dragging the economy down. Since 1988 in particular, Egypt's economic numbers have looked grim: per capita GNP has fallen by 0.2 percent a year.

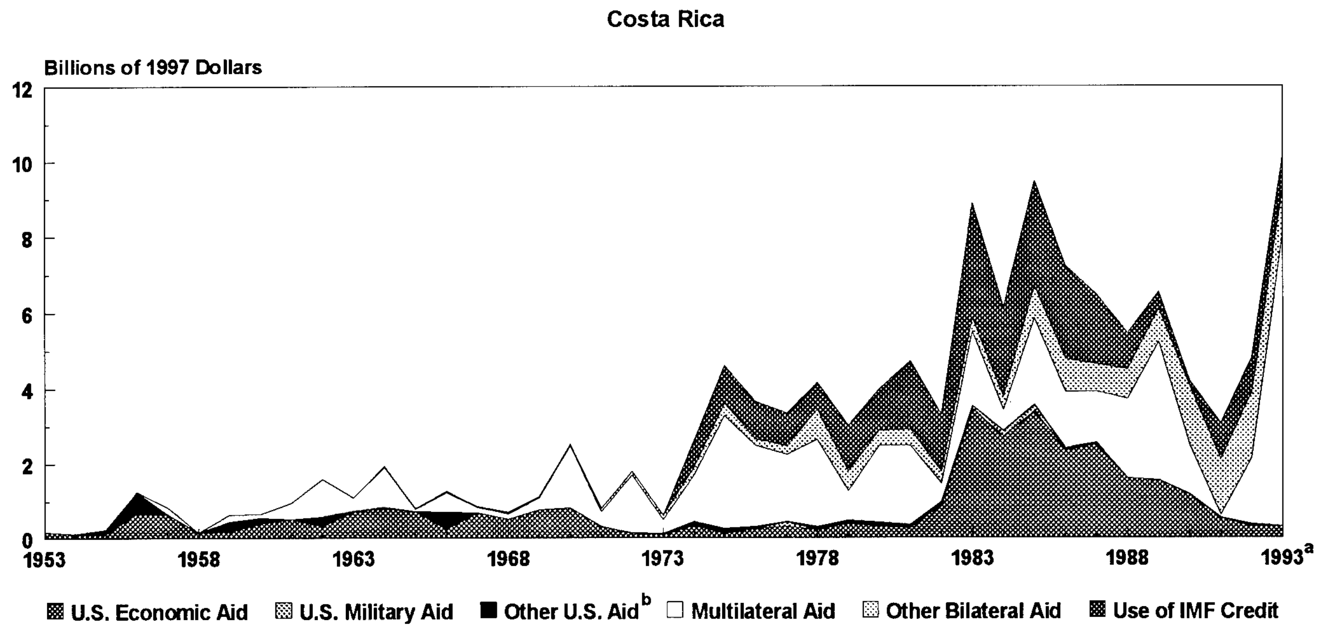
One expert has described Egypt's situation as one of "dependent development."[23] Marvin Weinbaum attributes the relative ineffectiveness of U.S. economic assistance not only to the unfavorable economic policies the Egyptian government pursued, but also to the seemingly guaranteed annual commitment by Washington of nearly a billion dollars in economic assistance. "AID officials cannot with much conviction threaten to withdraw or withhold funds from the government. U.S. influence over Egypt's broad development choices notwithstanding, the U.S. desire to assure Egypt's cooperation in international regional policies limits the demands the United States can impose."[24] Indeed, when Egypt is under severe economic distress, Western donors are likely to provide whatever financial assistance is necessary to ensure the survival of a moderate political regime in Cairo.

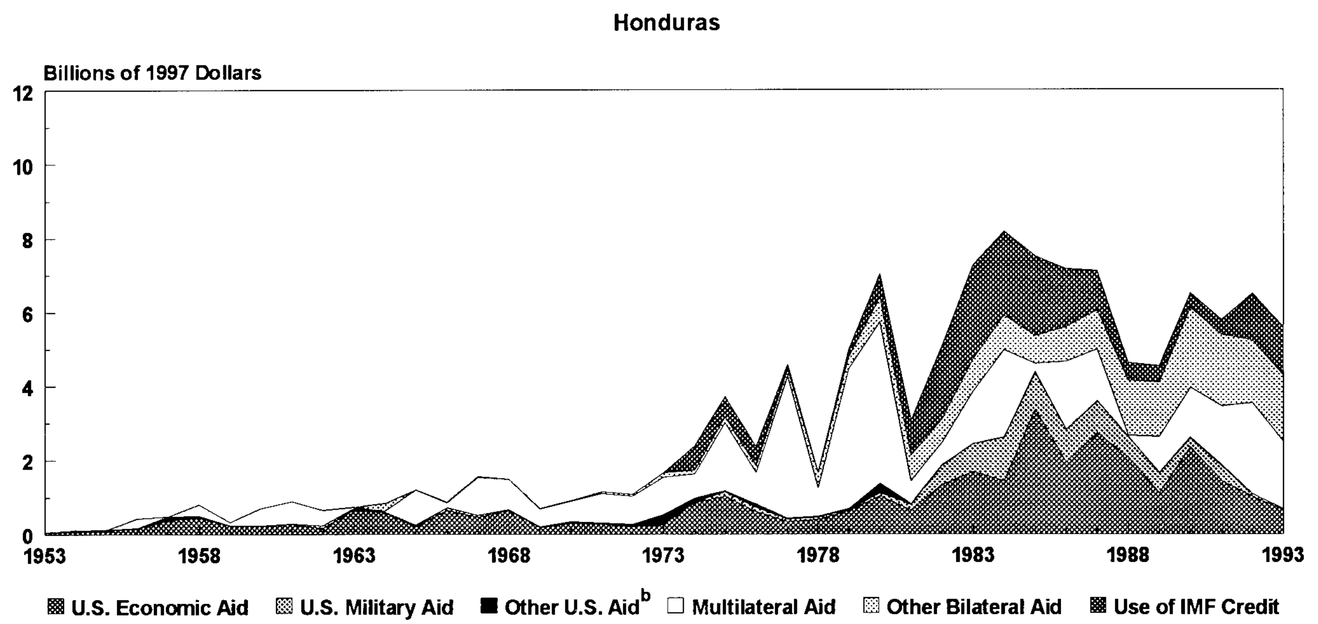
Costa Rica and Honduras. The U.S. government in the 1980s focused an extraordinary amount of attention on political and economic development in Central America. The United States made opposition to the Sandinista regime in Nicaragua a primary goal and pursued it by forming strong relationships with Costa Rica and Honduras as well as supporting the contras in Nicaragua. The National Bipartisan Commission on Central America, chaired by former Secretary of State Henry Kissinger, recommended in the early 1980s that the United States pursue large economic and military aid programs for the noncommunist governments of the region in order to promote democracy, encourage economic growth, and resist the spread of communism. The Reagan Administration embraced that policy, and U.S. foreign aid to Costa Rica and Honduras increased substantially (see Figure 7).

23. Marvin G. Weinbaum, *Egypt and the Politics of U.S. Economic Aid* (Boulder, Colo.: Westview Press, 1986), pp. 49-64.

24. Ibid., p. 64.

Figure 7.
Foreign Aid to Costa Rica and Honduras, 1953-1993





SOURCE: Congressional Budget Office based on data from the Agency for International Development, the Organization for Economic Cooperation and Development, and the World Bank.

NOTE: IMF = International Monetary Fund.

a. Aid to Costa Rica in 1993 represents a large loan from the Inter-American Development Bank that will be disbursed over several years.

b. Mostly loans from the Export-Import Bank.

U.S. aid to Costa Rica and Hondoras was also motivated by a desire to alleviate their economic problems and promote development. Both countries, in part through their own economic mismanagement, were experiencing an economic crisis. After years of overspending, protectionism, and poor management of the exchange rate, and in the wake of a decline in coffee prices that reduced export earnings, Costa Rica's financial system collapsed. Honduras also faced enormous difficulties.

In Honduras, the deficit widened, exports declined, and unemployment and underemployment together exceeded 50 percent. Development was financed by external borrowing, and debt-service payments soon exceeded 12 percent of export income. Rather than undertake reforms to open the economy, cut spending, and liberalize the exchange rate, the government responded with increased borrowing and spending. In response to that crisis, the International Monetary Fund and the Agency for International Development sought to impose fiscal and monetary discipline as a condition of foreign assistance. Honduras proved reluctant to accept such discipline, and both the United States and the IMF suspended aid in late 1983. The United States placed a high political value on supporting Honduras, however, and resumed cash transfers to the Honduran government shortly after they were suspended.

Thus, aid money in 1983 and 1984, from a developmental perspective, was largely unproductive. That tended to be the pattern for the U.S. aid programs to Honduras throughout the 1980s. Aid carried the Honduran economy until the 1990s, when the absence of reform caught up with the government and again sent the economy into a crisis. That time, however, the Honduran government was more willing to carry out reforms, but the long-term outlook remains uncertain.

In Costa Rica, the crisis in the early 1980s was even more severe than in Honduras as reflected in the decline in per capita GNP. Between 1981 and 1985, Costa Rica's declined by 22 percent compared with 10 percent for Honduras. Costa Rica was also politically important to the United States—though less than Honduras, which provided military and training bases for U.S. forces and served as an operating camp for the contra forces. The Costa Rican government, however, was more willing to undertake necessary economic reforms. Between 1982 and 1986, the United States took the lead in supporting and encouraging reforms, providing 58 percent of all foreign assistance given to Costa Rica. The major initiatives included liberalizing the financial sector, reducing the size and spending of the public sector, promoting nontraditional agricultural exports to diversify the economy, reducing trade barriers, and supporting general macroeconomic stabilization and adjustment.

The United States and other donors made foreign assistance conditional on the implementation of reforms. Without a government committed to making reforms, however, donors' efforts would probably have been fruitless. The result was that Costa Rica returned to a path of rapid economic growth and continuing improvement. Unemployment fell dramatically after 1983. Nontraditional exports to countries outside Central America more than doubled, and foreign direct investment in Costa Rica reached new highs in the 1990s.

In short, Honduras and Costa Rica illustrate two important points. First, the developmental objective of foreign assistance may be sacrificed to the political objective where the two conflict, which is what happened in Honduras. Second, the policy environment matters more in the development process than do the reasons for which a donor provides assistance. If a developing country is motivated to make reforms that will open the economy and foster growth, as in Costa Rica, even politically motivated aid can be helpful. If a government is not motivated to make such reforms, as in Honduras, politically motivated aid may actually undermine developmental objectives by making it easier for the government to avoid necessary reforms.

Contradictory Trade and Aid Policies of Donors

Egypt in the 1970s and 1980s serves as an example of how protectionist trade policies by major donors can undermine economic growth. In the 1970s, Egypt adopted an economic liberalization program and was pressured by the IMF to terminate special trade agreements with various countries and adopt a free-trade system. Despite considerable disruption to many Egyptian firms that were unskilled at advertising and selling their goods in new markets, such a system was in place by 1980. But it was not destined to last. Shortly thereafter, the United States and the European Community

(now called the European Union) created various protectionist barriers to Egyptian exports, such as import quotas on textiles, Egypt's primary manufactured export. As one analyst has written:

> A striking example was in 1986-87 when, after difficult and prolonged negotiations with the United States, Egypt's textile industry was only allowed to increase its annual quota to the United States by 6.5 percent for cotton yarn, cotton fabrics, and T-shirts, to reach a rough estimate of $70 million for 1987. No allowance seems to have been made for the fact that Egypt's staple raw material is cotton, that Egypt's textile exports to the United States started from a negligible base, that the United States' total imports of textiles are about $21 billion, or that Egypt's imports from the United States had soared from $610 million in 1976 to $2,323 million in 1985.[25]

Tied Aid

Despite the large share of U.S. assistance devoted to project aid to Egypt in the 1970s and 1980s—about 42 percent—one could argue that such aid has done relatively little to promote employment, production, or exports. For example, the first loan of $32 million to Egypt's private sector was made available in 1976, but disbursing the loan took five more years. According to Heba Handoussa, "the main problem seems to have been the tied loans, which forced private businessmen to purchase American machinery and equipment."[26] Overall, tied aid to Egypt has made projects costly because capital goods, technology, and technical assistance are packaged together and must be bought from the donor.[27]

25. Heba Handoussa, "The Impact of Foreign Aid on Egypt's Economic Development, 1952-1986," in Uma Lele and Ijaz Nabi, eds., *Transitions in Development: The Role of Aid and Commercial Flows* (San Francisco: ICS Press, 1991), p. 223.

26. Ibid., p. 220.

27. Ibid., p. 224. See also Weinbaum, *Egypt and the Politics of U.S. Economic Aid*, p. 51.

Coordination of Donors' Efforts

Recently, the coordination of donors has come under more scrutiny as a means to improve the effectiveness of foreign aid. In some countries, the proliferation of aid projects is so extensive that it is difficult to keep track of them all or to ensure that they are contributing to overall development. Of all the cases CBO examined, Botswana seems to have created the best system of coordinating donors.

The government of Botswana has identified its investment needs in its National Development Plan. That plan serves as a guide for public expenditures and investment; it does not plan the economy or control the

Table 16.
Sectoral Emphasis of Donors in Botswana in 1991

Donor	Emphasis
United States	Education Generating private-sector employment
Sweden	Water resources Training local government officials Small businesses
Norway	Health
Britain	Training public-sector officials
Germany	Energy Vocational training
China	Agriculture Railways
United Nations Development Programme	Population Food aid General technical assistance
African Development Bank	Infrastructure lending
World Bank Group	Infrastructure lending
European Union	Agriculture Health Natural resources

SOURCE: Congressional Budget Office based on data from the Agency for International Development.

private sector. It also serves as an investment guide for donors, since any project that is financed must be in the plan, and the recurrent costs must be incorporated into the national budget. The government's Ministry of Finance and Development Planning acts as donor coordinator, a role that gives the ministry greater influence in designing and establishing the projects. According to one study on Botswana's development process:

> The National Development Plans were constructed around a "shopping list" of projects for which finance was sought, which gave donors the flexibility to choose projects, but ensured that projects addressed government priorities. Each development plan listed projects, priorities, and expected foreign-exchange resources—including donors (who in some cases are yet to be identified when the plan is published). Donors selected projects to support and assessed how much support to give to Botswana's total programme, through project aid or general programme support.[28]

By encouraging individual donors to specialize in particular sectors of the economy, there is little duplication among donors (see Table 16 on page 55). By focusing on certain areas, donors have been able to learn from their experiences, and the staff of the Ministry of Finance and Development Planning works with the same organizations from year to year.

28. Gervase S. Maipose, Gloria M. Somolekae, and Timothy Johnston, *Aid Effectiveness in Botswana* (Washington, D.C.: Overseas Development Council, February 1996), pp. 47-48.

Appendixes

Appendix A

U.S. Spending on Foreign Aid

This appendix includes tables that provide a breakdown of U.S. spending on foreign aid by category and program. The six general categories are military assistance, bilateral development assistance, other development-related programs, humanitarian assistance, assistance to Eastern Europe and the republics of the former Soviet Union, and multilateral assistance.

Table A-1.
Appropriations for Military Aid in 1997

Program	Function	1997 Appropriation (Millions of dollars)
Foreign Military Financing	Funds U.S. overseas arms transfers. Primarily loans for Greece and Turkey and grants for Egypt and Israel.	3,284
Peacekeeping Operations	Provides U.S. contributions to operations in Sinai and Haiti as well as other training and monitoring of sanctions.	65
International Military Education and Training	Provides military training to selected foreign military and civilian personnel.	43
Military-to-Military Contact Programs	Supports exchanges between U.S. military personnel and counterparts in Eastern Europe and the Pacific.	0
		3,392

SOURCE: Congressional Budget Office.

Table A-2.
Appropriations for Bilateral Development Assistance in 1997

Program	Function	1997 Appropriation (Millions of dollars)
Development Assistance and Population	Funds the development activities of AID to promote growth, population stability, environmental protection, and democracy.	1,630
Agency for International Development	Funds operating expenses of AID, the organization that administers most U.S. bilateral economic assistance.	519
Peace Corps	Sends U.S. volunteers abroad to provide technical assistance and promote mutual understanding.	220
P.L. 480, Title III	Promotes policy reforms and food security goals in developing countries.	30
Debt Restructuring	Provides funds to reduce and forgive debts that poor countries owe to the United States.	27
Inter-American Foundation	Finances small-scale enterprise and grassroots activities aimed at helping poor people in Latin America.	20
African Development Foundation	Finances small-scale enterprises and grassroots activities aimed at helping poor people in Africa.	11
Housing Guarantee Program	Guarantees private loans that finance shelter and infrastructure projects abroad.	10
Micro and Small Enterprise Development	Promotes expansion of micro and small enterprises in developing countries.	2
Enhanced Credit Program	Permits AID to use market-rate loans and guarantees for leverage to support larger development projects than it could otherwise afford with grant-only programs.	n.a.
		2,469

SOURCE: Congressional Budget Office.

NOTES: The Economic Support Fund, though it is administered by the Agency for International Development (AID), is excluded from the table because it is explicitly reserved for countries that are politically and strategically important to the United States.

n.a. = not applicable.

Table A-3.
Appropriations for Other Development-Related Agencies and Programs in 1997

Program	Function	1997 Appropriation (Millions of dollars)
Export-Import Bank	Promotes U.S. exports by offering insurance guarantees and loans to U.S. companies operating or selling abroad, including in developing countries.	715
International Narcotics Control Program	Helps other countries counter the production, processing, and trafficking of illegal drugs.	213
P.L. 480, Title I	Makes low-interest loans to finance U.S. agriculture exports.	202
Nonproliferation, Anti-Terrorism, and Demining	Provides training and equipment for foreign civilian law enforcement to combat terrorism. Also provides funding for nonproliferation and programs to remove mines.	151
Trade and Development Agency	Finances feasibility studies and other services for major activities in developing countries to support economic development and U.S. exports.	45
Overseas Private Investment Corporation	Offers political risk insurance, guarantees, and investment financing to encourage U.S. firms to invest in developing countries.	-141[a]
		1,185

SOURCE: Congressional Budget Office.

a. Reflects loan repayments.

Table A-4.
Appropriations for Humanitarian Aid and Programs in 1997

Program	Function	1997 Appropriation (Millions of dollars)
P.L. 480, Title II	Provides humanitarian and emergency food grants.	837
Refugee Assistance	Supports refugee relief activities worldwide.	700
International Disaster Assistance	Assists nations struck by natural and man-made disasters and emergencies.	190
		1,727

SOURCE: Congressional Budget Office.

Table A-5.
Appropriations for Assistance to Eastern Europe and the Former Soviet Union in 1997

Program	Function	1997 Appropriation (Millions of dollars)
Newly Independent States of the Former Soviet Union	Regional program by which AID extends economic aid to those states.	576
Eastern Europe and the Baltic States	Regional program by which AID extends economic aid to Eastern Europe.	475
Cooperative Threat Reduction (Nunn-Lugar) Program	Promotes the dismantling of the nuclear arsenal of the republics of the former Soviet Union.	328
		1,379

SOURCE: Congressional Budget Office.

NOTE: The Cooperative Threat Reduction program is funded and administered through the Department of Defense. It is not part of budget function 150 (international affairs).

AID = Agency for International Development.

Table A-6.
Appropriations for Multilateral Organizations and Programs in 1997

Program	Function	1997 Appropriation (Millions of dollars)
World Bank Group		
International Bank for Reconstruction and Development	Makes loans at near-market rates to promote economic development in middle-income countries.	0
International Development Association	Makes loans at concessional rates to low-income countries.	700
International Finance Corporation	Makes loans and equity investments to promote growth of productive private enterprise in developing countries.	7
Multilateral Investment Guarantee Agency	Promotes private investment by offering insurance against noncommercial risks in developing countries.	0
Global Environment Facility	Makes grants to developing countries to deal with global environmental problems.	35
Asian Development Bank	Finances economic development programs in Asia and the Pacific at near-market rates.	13
Asian Development Fund	Makes loans at concessional rates to the poorest countries in Asia for development.	100
Inter-American Development Bank	Promotes economic and social development in Latin America and the Caribbean with loans at near-market rates.	26
Fund for Special Operations	Provides loans at concessional rates to the poorest countries in Latin America for development.	10
Inter-American Investment Corporation	Makes loans and equity investments to promote the growth of private enterprise.	0
Enterprise for the Americas Multilateral Investment Fund	Provides technical and financial assistance to help Latin American countries reform their investment policies in order to attract foreign investment.	28

(Continued)

Table A-6.
Continued

Program	Function	1997 Appropriation (Millions of dollars)
African Development Bank	Lends at near-market rates to countries in Africa emphasizing agriculture, infrastructure, and industry.	0
African Development Fund	Makes loans at concessional rates to low-income countries in sub-Saharan Africa, emphasizing health, education, and other social programs.	0
European Bank for Reconstruction and Development	Makes loans at near-market rates to help Eastern Europe and the republics of the former Soviet Union adopt market economies. Focuses on private firms as well as public firms that are privatizing.	12
North American Development Bank	Provides financing for environmental infrastructure projects in the border region between the United States and Mexico and for NAFTA-related community adjustment and investment to the United States.	56
Enhanced Structural Adjustment Facility	Subsidizes the interest on balance-of-payment loans from the International Monetary Fund to low-income countries.	0
International Organizations and Programs	Receive voluntary donations made in addition to the assessed contributions paid by the Department of State.[a]	272
		1,259

SOURCE: Congressional Budget Office.

NOTES: The International Bank for Reconstruction and Development, the Inter-American Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development have callable capital limits totaling $2.5 billion. Callable capital is a commitment by the United States to transfer additional resources in the event that borrowers from those multilateral development banks (MDBs) need, as a last resort, funds to repay their creditors. Callable capital does not require appropriations, and the MDBs have never made a call on this guarantee financing.

NAFTA = North American Free Trade Agreement.

a. The recipients of those donations are the United Nations Development Programme, the United Nations Children's Fund, the United Nations Environment Programme, the International Fund for Agricultural Development, and the International Atomic Energy Agency.

Appendix B

Economic and Social Indicators of Developing Countries

The development experience of eight countries was discussed in detail in Chapter 4. Tables B-1 and B-2 present economic and social indicators of more than 80 developing countries. The tables provide a useful compilation of data for comparing the experience of those countries.

Table B-1.
Economic Indicators of Developing Countries

	U.S. Economic Aid to Developing Countries (Millions of 1997 dollars)			GNP per Capita (1987 dollars)[a]			Official Development Finance as a Percentage of GNP, 1990-1993		Net Private Capital Flows as a Percentage of GNP, 1990-1993
	1961-1970	1971-1980	1981-1990	1961-1970	1971-1980	1981-1990	Gross Flows	Net Flows	
Low-Income Countries									
Zaire	203	53	71	244	196	339	n.a.	n.a.	n.a.
Chad	5	14	19	546	400	401	22.0	21.4	0.3
Tanzania	34	51	28	227	256	407	54.8	47.2	-0.1
Malawi	12	12	32	271	348	410	29.0	26.8	-0.8
Somalia	35	26	79	447	333	427	67.2	66.5	0.9
Sierra Leone	16	12	16	n.a.	440	500	24.8	19.1	7.2
Burundi	4	4	11	246	390	518	27.1	24.8	-0.5
Zambia	3	33	43	560	500	561	36.0	25.3	1.4
Burkina Faso	7	29	26	376	379	591	16.1	15.2	-0.3
Ghana	107	47	33	620	449	599	14.5	11.6	1.9
Guinea-Bissau	0	3	6	n.a.	299	599	49.5	48.0	-0.8
Nigeria	166	31	11	399	397	608	5.2	3.3	2.6
Madagascar	7	2	21	872	630	629	18.0	13.3	0.7
Myanmar	16	5	31	272	417	674	0.6	0.5	0
Niger	8	27	43	923	605	683	18.5	16.5	-1.6
Middle-Income Countries									
Mali	12	33	37	n.a.	565	736	18.5	17.5	-0.3
Central African Republic	2	3	6	1,082	935	740	16.5	15.5	-0.2
Togo	8	8	15	525	560	749	14.7	12.5	-1.9
Gambia	1	6	11	548	717	768	33.5	30.2	3.1
Mauritanlia	1	14	17	781	769	808	30.7	24.3	-0.4
Uganda	18	6	24	n.a.	n.a.	834	20.0	18.7	-0.3
China	0	0	0	123	273	844	1.2	1.0	5.2
Rwanda	3	5	17	1,004	858	885	19.9	19.3	0.3
Guyana	27	19	5	702	1,091	898	72.2	46.1	10.2
Kenya	34	52	90	429	613	918	18.1	13.2	1.9
Mozambique	0	11	45	n.a.	n.a.	963	110.9	101.1	-1.3
Zimbabwe	1	4	54	n.a.	787	1,119	13.5	11.8	1.3
India	2,878	565	286	554	694	1,199	1.8	1.3	0.5
Benin	6	12	5	1,097	958	1,212	15.7	14.5	n.a.
Bangladesh	0	481	248	657	676	1,250	9.0	7.9	0.2
Pakistan	1,256	365	437	439	664	1,267	5.0	3.6	2.0
Indonesia	308	473	146	580	552	1,333	4.9	3.2	4.5
Cameroon	15	12	37	996	820	1,415	9.4	7.0	-0.2
Senegal	17	28	67	1,255	1,146	1,423	15.1	12.3	-0.1
Bolivia	158	105	92	1,877	1,733	1,580	17.7	13.7	-0.3
Papua New Guinea	0	0	1	2,123	1,739	1,620	13.3	11.4	5.7
Côte d'Ivoire	14	5	5	1,471	1,751	1,624	15.6	11.3	0.2
Philippines	142	215	311	1,048	1,460	1,680	6.0	4.3	1.9
Honduras	41	55	187	1,217	1,605	1,745	20.3	12.7	2.0
Egypt	322	1,141	1,590	471	865	1,810	19.3	11.3	-1.2
El Salvador	56	30	407	1,981	2,499	1,860	9.2	6.0	-0.1
Paraguay	43	19	6	1,131	1,293	1,880	2.8	1.1	0.9
Dominican Republic	195	67	111	655	1,033	1,895	3.5	1.8	1.9
Lesotho	4	16	30	413	1,093	1,917	14.6	13.9	0.8
Guatemala	67	49	122	1,414	1,856	1,919	2.9	2.0	1.6
Sri Lanka	50	92	99	531	935	1,993	9.0	7.8	n.a.
Botswana	8	27	27	694	1,046	2,060	5.5	4.2	-1.4
Morocco	235	95	116	903	1,059	2,085	8.9	5.3	1.8
Swaziland	0	10	16	1,120	1,541	2,188	7.0	4.6	5.4

Table B-1.
Continued

	U.S. Economic Aid to Developing Countries (Millions of 1997 dollars)			GNP per Capita (1987 dollars)[a]			Official Development Finance as a Percentage of GNP, 1990-1993		Net Private Capital Flows as a Percentage of GNP, 1990-1993
	1961-1970	1971-1980	1981-1990	1961-1970	1971-1980	1981-1990	Gross Flows	Net Flows	
Middle-Income Countries (Continued)									
Congo	3	2	3	1,104	1,229	2,204	9.2	8.3	0
Peru	141	84	121	2,223	2,388	2,300	4.7	3.3	1.3
Jamaica	21	40	157	1,753	2,062	2,415	16.2	5.5	1.9
Upper-Middle-Income Countries									
Tunisia	246	75	48	1,003	1,424	2,628	7.9	4.9	1.5
Colombia	425	153	14	1,384	2,056	2,762	2.3	-0.2	2.1
Thailand	164	63	50	1,088	1,556	2,762	1.8	0.9	7.6
Ecuador	98	29	49	n.a.	2,149	2,770	4.2	2.5	4.3
Algeria	86	5	0	2,369	2,715	2,992	3.9	1.5	-1.6
Chile	393	73	6	2,107	2,215	3,187	2.4	0.9	5.5
Iran	136	3	0	n.a.	4,646	3,250	0.2	0.1	3.9
Panama	88	59	73	1,977	2,799	3,263	10.4	0.5	-1.8
Costa Rica	60	24	195	2,130	2,542	3,370	5.1	3.1	2.4
South Africa	0	0	16	2,994	3,239	3,535	0.2	0.2	n.a.
Brazil	970	83	2	2,044	2,777	3,714	0.8	0.1	2.2
Turkey	733	119	223	1,551	1,871	3,856	1.4	0.4	4.3
Jordan	186	197	65	n.a.	n.a.	4,015	20.4	16.7	-1.1
Malaysia	17	8	1	1,572	2,222	4,022	1.8	0.8	12.5
Gabon	4	3	3	4,880	5,261	4,127	6.4	4.4	-0.6
Mexico	76	13	28	2,404	2,892	4,241	1.4	0.7	5.8
Uruguay	45	13	4	4,880	4,163	4,546	2.5	1.7	0.6
South Korea	965	314	10	1,083	1,806	4,720	0.2	-0.2	2.1
Venezuela	90	5	0	3,658	4,347	4,895	1.9	2.1	3.1
Argentina	94	0	1	5,645	3,960	5,030	1.2	0.7	3.6
Mauritius	2	5	8	3,061	3,139	5,264	3.7	1.9	2.4
High-Income Countries									
Trinidad and Tobago	19	0	0	7,867	7,920	7,365	2.4	1.2	1.6
Saudi Arabia	0	0	0	6,108	8,445	8,030	0	0	n.a.
Singapore	1	0	0	2,466	4,493	8,911	0.4	0.2	n.a.
Israel	206	1,093	1,712	4,856	7,232	9,096	2.9	2.5	n.a.
Insufficient Data to Rank									
Liberia	69	39	74	783	925	n.a.	n.a.	n.a.	n.a.
Nepal	54	31	28	439	655	n.a.	11.7	11.3	-0.2
Vietnam	1,686	822	0	n.a.	n.a.	n.a.	3.6	3.2	1.6
Ethiopia	94	56	48	n.a.	n.a.	n.a.	13.8	13.2	0.5

SOURCE: Congressional Budget Office based on data from the Agency for International Development, the Organization for Economic Cooperation and Development, the University of Pennsylvania, and the World Bank.

NOTES: Countries are ranked according to GNP per capita from 1981 to 1990. The income categories and the countries assigned to each are roughly comparable with those used by the World Bank in its 1996 *World Development Report*. Data for U.S. economic aid and GNP per capita are 10-year averages, and those for official development finance and net private capital flows are four-year averages.

GNP = gross national product; n.a.= not available.

a. GNP per capita was calculated using estimates of purchasing power parity.

Table B-2.
Social Indicators of Developing Countries

	Infant Mortality Rate (Deaths per thousand live births)			Literate Population in 1990 (Percentage of population age 15 and over)	Population	
	1967	1992	Decline, 1967-1992		1994 (Thousands)	Percentage Growth, 1960-1994
Low-Income Countries						
Zaire	137	92	45	72	42,552	178
Chad	179	120	59	30	6,183	102
Tanzania	135	84	51	n.a.	28,846	183
Malawi	197	142	55	n.a.	10,843	207
Somalia	162	120	42	24	9,077	140
Sierra Leone	204	164	40	21	4,587	105
Burundi	140	101	39	50	6,209	111
Zambia	115	103	12	73	9,196	193
Burkina Faso	185	129	56	18	10,046	126
Ghana	117	79	38	60	16,944	150
Guinea-Bissau	189	138	51	37	1,050	94
Nigeria	118	83	35	51	107,900	155
Madagascar	195	93	102	80	13,101	144
Myanmar	136	82	54	81	45,555	109
Niger	176	122	54	28	8,846	192
Middle-Income Countries						
Mali	206	157	49	32	9,524	119
Central African Republic	150	101	49	38	3,235	111
Togo	141	83	58	43	4,010	165
Gambia	193	130	63	27	1,081	207
Mauritanlia	157	99	58	34	2,217	124
Uganda	118	114	4	48	18,592	183
China	81	30	51	73	1,190,918	79
Rwanda	143	109	34	50	7,750	183
Guyana	82	47	35	96	825	45
Kenya	108	61	47	69	26,017	212
Mozambique	175	146	29	33	16,614	123
Zimbabwe	101	67	34	67	11,002	189
India	145	80	65	48	913,600	107
Benin	160	85	75	23	5,246	135
Bangladesh	140	106	34	35	117,787	129
Pakistan	145	88	57	35	126,284	153
Indonesia	124	56	68	77	189,907	97
Cameroon	136	61	75	54	12,871	143
Senegal	154	67	87	38	8,102	154
Bolivia	157	73	84	78	7,237	116
Papua New Guinea	130	67	63	52	4,205	119
Côte d'Ivoire	143	91	52	54	13,780	263
Philippines	72	42	30	90	66,188	140
Honduras	119	41	78	73	5,493	190
Egypt	170	64	106	48	57,556	107
El Salvador	110	45	65	73	5,641	119
Paraguay	59	37	22	90	4,830	172
Dominican Republic	105	40	65	83	7,684	138
Lesotho	140	77	63	n.a.	1,996	129
Guatemala	108	46	62	55	10,322	160
Sri Lanka	61	17	44	88	18,125	83
Botswana	105	42	63	74	1,443	201

Table B-2.
Continued

	Infant Mortality Rate (Deaths per thousand live births)			Literate Population in 1990 (Percentage of population age 15 and over)	Population	
	1967	1992	Decline, 1967-1992		1994 (Thousands)	Percentage Growth, 1960-1994
Middle-Income Countries (Continued)						
Morocco	138	66	72	50	26,488	128
Swaziland	147	73	74	n.a.	906	178
Congo	110	84	26	57	2,516	155
Peru	126	63	63	85	23,331	135
Jamaica	45	14	31	98	2,496	53
Upper-Middle-Income Countries						
Tunisia	138	42	96	650	8,815	109
Colombia	82	36	46	87	36,330	128
Thailand	84	36	48	93	58,718	122
Ecuador	107	49	58	86	11,220	153
Algeria	150	53	97	57	27,325	153
Chile	89	16	73	93	14,044	85
Iran	145	35	110	54	65,758	205
Panama	52	24	28	88	2,585	130
Costa Rica	68	14	54	93	3,304	167
South Africa	83	52	31	n.a.	41,591	139
Brazil	100	57	43	81	159,143	119
Turkey	153	62	91	81	60,771	121
Jordan	n.a.	27	n.a.	80	4,217	400
Malaysia	50	13	37	78	19,498	140
Gabon	147	92	55	61	1,035	113
Mexico	79	35	44	87	91,858	149
Uruguay	47	19	28	96	3,167	25
South Korea	58	11	47	96	44,563	78
Venezuela	60	23	37	92	21,378	182
Argentina	57	24	33	95	34,180	66
Mauritius	67	17	50	n.a.	1,104	67
High-Income Countries						
Trinidad and Tobago	46	18	28	n.a.	1,292	53
Saudi Arabia	140	28	112	62	17,498	329
Singapore	24	6	18	n.a.	2,819	73
Israel	25	9	16	n.a.	5,420	156
Insufficient Data to Rank						
Liberia	173	123	50	40	2,941	183
Nepal	164	96	68	26	21,360	126
Vietnam	118	41	77	88	72,500	109
Ethiopia	167	117	50	n.a.	53,435	135

SOURCE: Congressional Budget Office based on data from the World Bank.

NOTES: Countries are ranked according to average gross national product per capita from 1981 to 1990 as presented in Table B-1.

n.a. = not available.

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